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Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F St NE
Washington DC 20549-1090

RE: Concept Release on Harmonization of Securities Offering Exemptions
File No. S7-08-19

Ladies & Gentlemen:

We are fifteen law professors whose scholarship and teaching focuses on securities regulation. We appreciate the opportunity to comment on the U.S. Securities and Exchange Commission's ("SEC" or the "Commission") Concept Release on Harmonization of Securities Offering Exemptions (the "Concept Release").

We believe that the Commission's regulatory regime for transaction exemptions (*i.e.*, exemptions from Section 5 of the Securities Act of 1933 (the "Securities Act")) could be rationalized in a manner that protects investors and promotes capital formation. However, rationalization or harmonization does not necessarily equate with expanding exemptions. The number and scope of exemptions already has been dramatically expanded over several decades, with this expansion only accelerating since the financial crisis. Congress and the Commission have, over this period, dramatically liberalized the ability of issuers to raise capital outside of public markets.

The remarkable growth in private capital has come at least in part at the expense of the public markets. The number of public companies has fallen significantly over the last 20 years,[1] and private capital-raising now outpaces public capital-raising by a substantial factor.[2] The decline in the number of public companies and initial public offerings is a complex phenomenon, with several contributing factors.[3] Yet the deregulation of private capital by Congress and the SEC over the last few decades—including the expansion of transaction exemptions—has clearly played a large role, by allowing even very large firms to delay or avoid going public. The private and public markets are to some degree substitutes for one another, in terms of their ability to attract issuers and investors, and regulators should be aware of the tradeoffs involved in expanding private capital.

Without question, the private markets play a significant and important role in financing U.S. businesses. Yet rather than continuing to expand exemptions from securities

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[1] *See* Craig Doidge et al., *The U.S. Listing Gap*, 123 J. FIN. ECON. 464 (2017).

[2] *See* Scott Bauguess et al., Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009–2014 (2015), https://www.sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf.

[3] *See, e.g.*, Xiaohui Gao et al., *Where Have All the IPOs Gone?* 48 J. FIN. & QUANTITATIVE ANALYSIS 1663, 1677–79 (2013) (attributing the decline in IPOs to technological changes requiring small companies to achieve scale faster); Robert P. Bartlett III et al., *The Small IPO and the Investing Preferences of Mutual Funds*, 47 J. CORP. FIN. 151 (2017) (providing evidence that the sharp decline in small company IPOs was triggered by mutual funds' preference for liquidity).

registration, we should pause to ask whether doing so undermines the *public* markets that have served retail and institutional investors so well. We hold differing views on the appropriate regulation of public companies and the public markets. Nonetheless, we all agree that the private markets cannot replicate what the public markets have achieved solely through private ordering. There are significant collective action problems and agency costs in corporate finance that hinder price discovery, liquidity, and information quality in the absence of regulation.[4] Therefore, we believe that robust public markets are crucial to continued economic growth in the United States.

The initial step in designing rules to "harmonize" transaction exemptions, we believe, should be to require that issuers and securities intermediaries provide greater information to the Commission about their use of transaction exemptions. This information should then be made available to academics and the public for analysis and comment. Collecting this information may require changes to filing requirements for existing transaction exemptions. More data on the use of existing exemptions would help Congress, the Commission and the public answer vital questions before the Commission pursues any rule changes that would enlarge the scope of transaction exemptions.

1. Public Markets Represent the Gold Standard for Investor Protection and Capital Formation

Any consideration of the regulatory web of transaction exemptions should begin with an acknowledgement that public securities markets, which are the product of SEC-registered offerings, remain the standard against which securities offerings and markets should be judged. Since the end of World War II, U.S. public securities markets have been the envy of the world in terms of size and liquidity and as engines for capital formation. This status owes not just to the economic might of the United States, but moreover to the legal architecture of federal securities laws, built over eight decades, which has protected investors. These statutes and rules restored investor confidence, which was shattered by the Crash of 1929 and the Great Depression. In so doing, these legal rules provided the scaffolding for the creation of deep and vast public securities markets that helped American businesses raise trillions of dollars in capital.

There is considerable room for disagreement over whether public companies and the public markets are subject to too much regulation, and we hold differing views on this. Whether or not that is the case, however, we believe that Congress and the Commission should be especially cautious about further expanding opportunities for issuers and investors to circumvent the public markets entirely or making rule changes that risk draining liquidity from public markets.

Public markets have succeeded in protecting investors, promoting investor confidence, and attracting liquidity thanks to an array of legal rules that are absent or much weaker in markets for private or exempt offerings. These legal rules include the following:

¶ *Mandatory Disclosure:* The Securities Act and the Commission's regulations under that statute require that issuers disclose a broad range of information to investors. These rules help address severe information asymmetries that afflict capital markets and help

[4] *See, e.g.*, John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

investors minimize agency costs by enabling the monitoring of managers. Even prominent academic critics of mandatory disclosure have acknowledged the valuable role that these rules play in standardizing information provided to investors. This standardization enables investors to make quality comparisons among issuers and securities.[5]

¶ *Remedies:* Federal law provides investors in public markets a broader range of remedies for fraud compared to those in private markets, including Sections 11 and 12(a)(2) of the Securities Act. Although the signatories to this letter may disagree about whether these private rights of action have imperfections, we agree that they provide antifraud protections beyond those that exist in private markets.

¶ *Oversight:* Public rights of action, including under Sections 17 and 24 of the Securities Act, provide additional layers of antifraud protection in public markets. Public markets are subject to a much more intense level of oversight by federal regulators as well as self-regulatory organizations ("SROs") compared to private markets.

The regulatory regime of disclosure, remedies, and oversight helps create and supports the functioning and growth of public markets. This regime enables public markets to achieve a high degree of informational efficiency so that there are transparent market prices for public securities and those prices generally reflect all available public information. Public markets benefit from other features that contribute to this informational efficiency. These include third-party research, exchanges, and market makers, all of which are regulated in the public markets.[6]

This web of institutions and regulation and public market institutions benefits retail investors even if they do not read the disclosure provided. The logic of market efficiency is backed by decades of empirical finance research. As elaborated further below, the mechanisms, evidence, and benefits of market efficiency are largely absent from private markets.

This points to an important spillover benefit: the pricing of securities in private markets often relies on prices in public markets for reference points. The stock of public companies serve as the inputs for index funds, which, as we explain below, offer retail investors returns and diversification at low risk. The transparent and efficient pricing of public company securities also enables them to serve as collateral for other financial transactions. Changes that shrink the size and liquidity of public markets thus impose spillover costs on other financial markets.

Informationally efficient public markets level the playing field for retail investors, and regulations play a crucial role in this. Regulation FD curbs selective disclosures in public markets but not private ones. As we explain below, as a practical matter, insider trading laws are difficult to enforce outside of public markets. Public disclosure, antifraud protections, and the mechanisms of market efficiency, together with requirements for audited financials, all combine to ensure the

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5 Frank H. Easterbrook & Daniel A. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 687, 701 (1984).

6 Scholars have recognized for decades the mechanisms that promote informational efficiency in public markets. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

integrity of information in public markets. A level playing field and informational integrity are essential to investor confidence. The difficulties of quantifying investor confidence should not lead to a dismissal of its importance.

Informational efficiency both depends on and catalyzes the deep level of liquidity in public markets. This liquidity enables investors to enter and exit investments easily. The ease of exit helps retail investors meet their cash needs. The exit enabled by liquid public markets also provides a crucial tool in disciplining companies and management with poor financial performance, as well as those that have engaged in misconduct or that are otherwise not serving the interests of their investors. Moreover, the liquidity of public markets also narrows spreads to the benefit of investors. Investors in public markets benefit from lower commissions and best execution for trades.

Shareholders of public companies benefit not only from transparent and informationally efficient prices, but also from a range of corporate governances rules, including a well-established proxy process, independent audit committees, and stock exchange listing standards. In short, public markets help investors mitigate the agency costs that result from the separation of ownership and control. Retail investors can enjoy the benefits provided by public markets without needing to overcome daunting collective action problems, to accumulate substantial bargaining power, or to invest impractical amounts of time negotiating for, and analyzing volumes of, crucial information.

2. Private Securities Markets Pose Risks to Retail Investors

The Concept Release seeks public comment on various proposals to expand or create new exemptions from registration under the Securities Act, or to loosen the restrictions on the secondary trading of private securities. To be very clear, such proposals would have the primary effect of allowing small-dollar retail investors to invest *directly* in private securities. Indeed, issuers are already permitted to raise unlimited amounts of capital privately from institutional and high-net-worth investors, without significant disclosure obligations.[7] Some exemptions require no disclosure whatsoever.[8]

Yet investing in private securities would pose considerable additional risks for retail investors, relative to investing in public securities, and existing research suggests that these additional risks would not be sufficiently offset by higher expected returns.

In fact, if retail investors are given more direct access to the private markets, they are likely to earn *lower* risk-adjusted returns overall than they do in the public markets, for several reasons:

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[7] Moreover, existing exemptions also allow retail investors to purchase private securities. For example, in 2016, the Commission amended Rule 504 of Regulation D to allow exempt issuances of up to $5,000,000 in securities in any 12-month period. Under Rule 504, offerees and purchasers need not be accredited investors. Prior to the amendment, the cap was $1,000,000 in any 12-month period.

[8] For example, under Rule 506(b) of Regulation D, issuers may raise an unlimited amount of capital with no required disclosures to investors, so long as the securities are offered only to "accredited investors." See 17 C.F.R. § 230.506(b). Under this exemption, the issuer's only "disclosure" obligation is the filing with the SEC of Form D, a simple two-page notice providing summary information about the issuance.

A. *Evidence is mixed as to whether even large institutional investors achieve better risk-adjusted returns in the private markets than in the public markets, with recent evidence suggesting a convergence of returns in the two markets.*

Because retail investors are currently confined to the public markets, for the most part, the Concept Release inquires whether retail investors may be missing out on favorable investment opportunities in private securities that are available only to institutional and high-net-worth investors. The unstated assumption is that investors obtain better returns in the private markets than in the public markets.

The evidence does not support this assertion, however, even for institutional investors.[9] Contrary to the received wisdom, the most recent and comprehensive studies show that the returns from investing in the public and private markets have been converging over time, and any excess returns in the private markets have mostly dissipated today.[10] Such convergence is precisely the result one would expect, given how much capital has shifted to the private markets and how competitive private markets have become for investors.

Evidence showing outperformance of the private markets relative to the public markets are based on data from earlier decades, when private equity and venture capital were relatively new asset classes. Facing little or no competition for investments, many such funds could boast of market-beating returns. That is no longer the case today, when the number of private investment funds and the capital that they manage have skyrocketed, leading to fierce competition and substantially lower returns. Ironically, one of the most frequently cited studies for the proposition that the private markets outperform the public markets makes this explicit: the authors find that returns to investors in private equity funds with post-2005 vintage years have been roughly equal to returns in the public markets.[11]

Even this evidence overstates the returns to the average institutional investor in the private markets, however. Because studies of the private markets rely primarily on limited, voluntarily reported data, they cover the performance of only the largest and most successful institutional investors, investing in the largest and most successful investment funds.

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[9] In particular, the performance of private equity funds as reported by industry associations and much prior research is significantly overstated. *See* Ludovic Phalippou & Oliver Gottschalg, *The Performance of Private Equity Funds*, 22 REV. FIN. STUD. 1747 (2009).

[10] For studies documenting the decline in returns to private equity investors over time, see, e.g., Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, *How Do Private Equity Investments Perform Compared to Public Equity?*, 14 J. INV. MGMT. 14, 15 (2016); Ludovic Phalippou, *Performance of Buyout Funds Revisited?*, 18 REV. FIN. 189, 189 (2014); Ludovic Phalippou & Oliver Gottschalg, *The Performance of Private Equity Funds*, 22 REV. FIN. STUD. 1747, 1747 (2009); Berk A. Sensoy, Yingdi Wang & Michael S. Weibach, *Limited Partner Performance and the Maturing of the Private Equity Industry*, 112 J. FIN. ECON. 320, 341-42 (2014).

[11] *See* Harris et al., *supra* note 10, at 15.

Thus, the best evidence today suggests that, on average, *even institutional investors may be doing no better in the private markets than they would investing in a broad index of public securities.*[12]

B. *Retail investors would be highly unlikely to gain access to the same issuers and investments in the private markets as institutional investors.*

Capital is currently abundant and cheap in the United States, in both the public and private markets, due to our prolonged period of historically low interest rates. Private firms face a seemingly bottomless supply of capital from institutional and high-net-worth investors, including venture capital funds, private equity funds, private credit funds, business development companies, angel investors, and direct investment from sovereign wealth funds, pension funds, and others.

The number of investment funds targeting the U.S. private markets has grown exponentially over the last few decades,[13] leading to vigorous competition for investments and a growing sense of overcrowding. Large operating companies are also eagerly competing to invest in private firms: these "strategic" acquisitions have long replaced the IPO as the primary exit for venture capital investments. In this highly competitive environment, capital is far from scarce. The notion that institutional investors may have passed over a large set of attractive private investments is therefore implausible. There is simply no evidence that issuers with reasonable prospects for growth and profitability currently lack capital in the private markets.

Therefore, the private issuers that seek out direct investment from small-dollar retail investors are likely to be the smallest issuers with the worst prospects—the product of severe adverse selection, if not outright fraud.[14] It would be ill-advised to steer retail investors towards these firms, when decades of research in financial economics suggest that they would be poor investments for retail investors, and that such firms are not equipped to manage passive investments from dispersed equity holders.

In conclusion, there is no basis for believing that small-dollar retail investors would have access to good investments on good terms in the private markets. The Commission should be wary of the availability bias, which can lead to excessive focus on the few "unicorn investments" that produce outsized returns, rather than on the far greater number of startup investments that lose money.

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[12] Even if one could show that institutional investors earned superior returns in the private markets, the excess return would likely be compensation for the additional liquidity risk associated with private securities. Investments in private firms and in the private markets are considerably harder to sell quickly and with low transaction costs than in the public markets. Institutional investors are well suited to bear liquidity risk; retail investors are not.

[13] *See* Javier Espinoza, *Private Equity Funds Active in Market Reach All-Time High*, FIN. TIMES (Apr. 25, 2018), https://www.ft.com/content/c74e10c6-47d2-11e8-8ae9-4b5ddcca99 b3 (describing record-breaking fundraising by private equity funds).

[14] We note that these adverse selection problems may exist even in other stages of the market cycle. Institutional investors have more resources and longstanding relationships with market intermediaries than retail investors. This affords institutional investors greater access to the most promising investments even independent of regulatory restrictions. For an analysis of adverse selection problems in public and private securities offerings, see Merritt B. Fox, *Regulating the Offering of Truly New Securities: First Principles*, 66 DUKE L.J. 673 (2016).

This adverse selection faced by retail investors in the private markets has two further implications.

First, studies showing returns to very large institutional investors in the private markets are simply not predictive of what the returns to small-dollar retail investors would be: rather, such studies represent an unachievable upper bound on those returns.

Second, these investments would be highly unlikely to meet FINRA's "suitability" standard and the SEC's recently adopted Regulation Best Interest in order for brokers to recommend them to retail investors.[15] Given that, it seems particularly problematic that the SEC seeks to allow small-dollar retail investors to invest *directly* in such securities. The Commission should be concerned that encouraging more direct retail investment in private securities may result in both more unregulated parties promoting transactions for retail investors and significant downward pressure on suitability and fiduciary standards for regulated investment professionals.

C. *Even if retail investors could gain access to the same investments as institutional investors, we would expect their investment performance to be materially worse, due to severe information asymmetry and greater liquidity risk.*

Contrary to the public markets, retail investors in the private markets would face a strikingly uneven playing field relative to corporate insiders and more sophisticated investors.

1. <u>Information Asymmetry</u>.

Unlike in the public markets, where securities prices are believed to incorporate all available information, investors in the private markets must determine the value of securities themselves.

The amount of information available in the private markets is very limited, and is distributed unevenly across investors, even in the very same firm.[16] Private securities are also largely illiquid—that is, there is dramatically less trading than in the public markets. The combination of these two factors means that there is generally no single "market price" at any given time for private securities, and there is no reason to believe that the pricing of private securities is efficient. Recent anecdotes abound regarding severe valuation discrepancies for even the largest private firms.

Accordingly, *access to information is crucial for valuing private securities*. Unfortunately, even assuming that retail investors were sophisticated enough to value private securities, they would be unlikely to have access to the necessary information. Because they are not subject to the mandatory disclosure regime that applies in the public markets, private issuers are not required to disclose even

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[15] *See* James D. Cox, *Who Can't Raise Capital? The Scylla and Charybdis of Capital Formation*, 102 KY. L.J. 849, 862 (2013) ("[I]t is difficult to believe that investing in a small business, and particularly one with little operating history and little liquidity for its shares, is appropriate for the investor who is neither accredited nor sophisticated.")
[16] *See* Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 235–36 (2012).

the most material information affecting them, such as the loss of the firm's largest customer, the departure of the CEO, or the initiation of a major lawsuit or government investigation.

For the most part, nothing prevents private firms from providing differential disclosure or no disclosure at all to their investors. While institutional investors with sufficient bargaining power typically negotiate for certain information rights from private issuers,[17] *retail investors in the very same firms might have no information rights whatsoever*.[18]

In those instances in which retail investors might have relationships with company insiders to afford them access to information, we note that Section 4(a)(2) already provides an exemption from registration. Issuers can face significant uncertainty as to when Section 4(a)(2) applies, but this has the benefit of requiring issuers to be very confident that a retail investor does not need the protection of the Securities Act before proceeding with an offer or sale.

2. Liquidity Risk.

Retail investors have liquidity needs that institutional investors typically do not, meaning that retail investors cannot keep their capital invested indefinitely. However, private securities are largely illiquid, in stark contrast to public securities.[19] First, investors in private firms may not be permitted to sell their securities at all, whether due to restrictions imposed by the securities laws or by the issuers themselves. Even when permitted to sell, they may be unable to find a buyer, given the lack of publicity and lack of information about the issuer. If they are able to sell their securities, for example through a broker or a secondary market for private securities, the high transaction costs and bid/ask spreads could easily eliminate any gain on the sale.

At the same time, opening up retail investment in private markets would place enormous pressure on resale restrictions, which could undermine the design of transaction exemptions including provisions that protect investors.

3. Dilution Risk.

Even if retail investors managed to access the rare startup that ultimately proved to be a success, they would still have no guarantee of emerging with a large payoff. Emerging companies raise needed funds in stages, with progressively larger and more sophisticated investors at each round, until the firm finally has a liquidity event via acquisition or IPO. Experience confirms

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[17] *See* Nat'l Venture Capital Ass'n, Investor Rights Agreement 20–23 ("Information and Observer Rights"), http://nvca.org/resources/model-legal-documents/ (last visited Sept. 21, 2019).
[18] To illustrate this concern, consider that before it went public earlier this year, the car sharing service Uber was the largest of the private company unicorns. In January 2016, while raising additional equity capital at a $62.5 billion valuation, its shares were marketed to high-net-worth individuals who were not given any financial statements whatsoever for the company. *See* Julie Verhage, *Here's What Morgan Stanley Is Telling Its Wealthiest Clients About Uber*, BLOOMBERG (Jan. 14, 2016, 6:42 AM), *available at* http://www.bloomberg.com/news/articles/2016-01-14/here-s-what-morgan-stanley-is-telling-its-wealthiest-clients-about-uber.
[19] *See* Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531, 548-50 (2012) (describing the factors that render private company equity illiquid).

that earlier-round investors face substantial threats of dilution with each successive round of financing. Experienced early investors such as venture capital funds protect themselves against this threat through various private ordering devices. There is no reason to expect that retail investors would be sufficiently coordinated or experienced to protect their gains against future appropriation through succeeding dilutive investments.[20]

This is also reason to interrogate the idea that retail investors are being precluded from earning outsized returns in startup companies. "Friends and family" investors even in those issuers that succeed often have their returns diluted by later, sophisticated institutional investors such as venture capital funds.

4. Lack of Recourse.

If a private firm is performing poorly, or there is misconduct by the management team or controlling stockholders, retail investors would likely be the last to be informed, if ever. And unlike in the public markets, there is little chance that they would have adequate recourse to correct the problem or to be compensated for their losses.

To take only one example, while the prohibition on insider trading applies both to public and private securities, it is extraordinarily difficult to detect and to enforce in the private markets, due to the lack of mandatory disclosure and the absence of a continuous market price for the issuer's securities. Thus, even if retail investors were able to invest alongside institutional investors in the private markets, they would be at the mercy of not only issuers and insiders, but also institutional investors with considerably more bargaining power, more sophistication, and more information.

Some commentators may argue that limitations on transaction exemptions deprive retail investors of the greater returns that come with more opaque and illiquid investments. However, policy should be driven by data rather than rhetoric or anecdotes about early investors in tech companies.

3. Retail Investors Raise Unique Concerns That Caution Against Investing in Private Securities

Retail investors' overall track record is not encouraging, even in the public markets. Decades of finance research support the policy of encouraging retail investors to invest in low cost index funds. The fact that we have finally achieved some success in steering retail investors' 401(k) investments to low-cost index funds of public securities should be considered one of the crowning achievements in investor protection of the last decade. It is worth noting, however, that it took decades to make progress on this front, during which time retirement investors collectively lost or passed up billions of dollars per year as a result of poor investment choices, excessive fees, and transaction costs, typically without ever realizing it.[21] Encouraging retail investors to invest directly in

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20 *See* James D. Cox, *Who Can't Raise Capital? The Scylla and Charybdis of Capital Formation*, 102 KY. L.J. 849, 854 (2013).

21 *See* WILLIAM A. BIRDTHISTLE, EMPIRE OF THE FUND: THE WAY WE SAVE NOW 71-88 (Oxford University Press, June 2016). Professor Birdthistle estimates the minimum annual fee revenue to the mutual

private securities would be fundamentally at odds with this achievement. Encouraging investments in private securities would not only increase the risk for retail investors, it would also drain liquidity from public securities, which are the inputs to index funds.

Institutional investors often allocate a portion of their capital to the private markets on the theory that they provide additional diversification, because the returns in the private markets may not be perfectly correlated with those in the public markets.[22] This rationale does not apply to small-dollar retail investors. With limited funds to invest and limited opportunities in private securities, retail investors would almost certainly *increase* their overall risk and *reduce* their portfolio diversification by allocating funds to direct private investments.

We applaud the Commission's interest in promoting diversification for retail investors, but believe that other initiatives, such as improving the intelligibility of mutual fund fee disclosures for retail investors, offer far greater and more certain benefits than opening retail access to private markets.

4. Proposals to Increase Retail Investor Participation in Private Securities through Pooled Investment Vehicles Suffer from Similar Misconceptions about the Private Markets

As an alternative to direct retail-investor participation in the private markets, the SEC's Concept Release seeks comment on various proposals designed to increase opportunities for retail investors to invest in private securities *indirectly*, through pooled investment vehicles such as open-ended investment companies (mutual funds), closed-end funds, interval funds, and tender offer funds. Other commenters have proposed allowing retail investors to invest in a fund-of-funds that would in turn invest in private equity funds or venture capital funds.

First, it is worth noting that retail investors can already access the private markets indirectly through channels such as (1) mutual funds that invest in late-stage private firms, (2) BDCs, and (3) publicly-traded private equity firms.

Second, these proposals implicitly seek a pooled vehicle structure for retail investors with features that cannot coexist in practice: liquidity for the investors; investment in illiquid private securities; investment in small issuers; broad diversification; good risk-adjusted returns; and, presumably, no need for retail investors to monitor the fund manager and the investments themselves. None of the current proposals for a pooled investment vehicle for retail investors would plausibly combine all or even most of these desired features.

To give one example, private equity funds often invest in no more than 5-7 portfolio companies during their 10-year lifespan, such that they cannot reasonably be characterized as diversified. This would represent a degree of risk that is unjustified for a retail investor with very

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fund industry to be approximately $100 billion. *See id.* at 62. Of that amount, a conservative estimate would be that shareholders are paying tens of billions annually in fees for actively managed funds, rather than cheaper and better performing index funds.

[22] *See* SEC Concept Release at 173 ("Retail investors who seek a broadly diversified investment portfolio could benefit from the exposure to issuers making exempt offerings, as these securities may have returns that are less correlated to the public markets.")

limited funds to invest. A fund-of-funds that invested in multiple private equity funds could ameliorate the diversification problem slightly, but the fees charged by the manager of the fund would chip away at returns significantly. And these returns would vary substantially depending on the quality of both the manager and the underlying funds, something that retail investors are not suited to evaluate.[23]

Indeed, the proposal of a fund-of-private-equity-funds for retail investors appears to suffer from three common misconceptions about the private markets:

(1) that investors earn higher risk-adjusted returns in the private markets than the public markets;
(2) that investing in the private markets would allow retail investors to invest in "the next Google;" and
(3) that investing in the private markets would offer additional diversification to retail investors already invested in the public markets.

To the first point, as discussed above it is not clear that even large institutional investors earn higher risk-adjusted returns in the private markets today than in the public markets. The most recent evidence suggests instead that private-market and public-market returns are converging for institutional investors. A fund-of-funds for retail investors would add another layer of fees on top of that, further lowering returns.

The idea that accessing the private markets will allow retail investors to invest in "the next Google" is inaccurate for several reasons. In order to be assured of having access to the high-growth issuers that generate major returns, retail investors would not only have to invest in a diversified portfolio of private securities, they would have to hold the "market" portfolio—that is, a share of *all* private securities. Indeed, in the public markets, *just 4% of listed U.S. companies accounted for all of the gains of the U.S. stock market from 1926 to 2016*.[24] Investors who did not hold shares in this vanishingly small set of issuers would have missed out entirely on the gains in the public markets. This is why market index funds are so beneficial to investors: they provide access to the tiny set of out-performers, without requiring investors to guess which ones the winners will be.

Yet there is no way to create such an index fund for private securities or to hold "the market" for private securities, even with a fund-of-funds. First, even regulators do not know the full universe of private securities outstanding at any point in time. Second, because private securities are relatively illiquid and generally subject to restrictions on resale, no investor is guaranteed access to any specific issuer's securities. If all of the gains in the private markets are generated by a very small proportion of issuers (as they are in the public markets), investors hoping to invest in "the next Google" by investing in the private markets are most likely to miss out entirely.

Finally, a common justification for allowing retail investors to access the private markets is the claim that they provide returns that are not perfectly correlated with the public

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[23] As a comparison point, decades of research confirm that retail investors' track record of picking mutual fund managers is poor. *See* Birdthistle, *supra* note 19.

[24] Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills?*, 129 J. FIN. ECON. 440 (2018). *See also* Hendrik Bessembinder et al., *Do Global Stocks Outperform US Treasury Bills* (2019), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3415739.

markets, creating additional diversification for investors in the public markets.[25] As discussed above, the diversification rationale does not apply to small-dollar retail investors with limited funds to invest. Moreover, as the private markets continue to become more competitive, we should expect more correlation with the public markets. Private firms are subject to the vagaries of the business cycle, just as public firms are.[26] For similar reasons, claims that investments in the private markets are less volatile than the public markets are also likely inaccurate.[27]

5. The Universe of Existing Exemptions Accommodates Retail Investor Participation

A. Exemptions already allow retail investment in private markets.

In cases in which retail investors might have access to information or bargaining power, such as when "friends and family" have close relationships with startup company founders, existing exemptions, notably Section 4(a)(2) of the Securities Act, already apply. Exemptions, notably Regulation D, also apply in cases where the number of potential retail investors are small enough that they might solve the collective action problems to bargain for more information from issuers.

B. Core policy concerns – protecting investors and promoting capital formation – should shape transaction exemptions, not the other way around.

Regulation D seems to offer a much more permissive and attractive exemption to issuers than any other exemption. When Congress and the Commission created or expanded transaction exemptions such as crowdfunding and Regulation A in the JOBS Act and regulations under the statute, they also liberalized the use of Regulation D. This should not lead to efforts to expand other transaction exemptions merely to "compete" with Regulation D or to attract greater transaction volumes. That could lead to a ratchet effect in which the liberalization of one transaction exemption places pressure to liberalize other exemptions without regard for the underlying value of investor protection.

C. Transaction exemptions limit risk of losses to investors.

In looking to investor net-worth or annual income, the Accredited Investor definition presents a crude proxy for the ability of investors to access and understand information about issuers. However, these net-worth and income tests also have a secondary benefit of limiting exempt transactions to investors who are better able to bear losses without catastrophic consequences to their personal finances. This same logic of limiting total risk exposure applies not only to Regulation D, but also to the structure of other transaction exemptions, such as

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[25] *See* footnote 22 and accompanying text.

[26] Private equity returns, for example, are highly cyclical, which calls into question the view that private equity offers significant diversification benefits relative to investing in public equities. *See, e.g.*, Viral V. Acharya, Julian Franks & Henri Servaes, *Private Equity: Boom and Bust?*, 19 J. APPLIED CORP. FIN. 44, 46 (2007); Andrew Ang et al., *Estimating Private Equity Returns from Limited Partner Cash Flows*, 73 J. FIN. 1751, 1751 (2018).

[27] *See* Andrew Ang et al., *Estimating Private Equity Returns from Limited Partner Cash Flows*, 73 J. FIN. 1751, 1782 (2018) (concluding that volatility for private equity is at least as high as for standard equity indices); Daniel Rasmussen, *Private Equity: Overvalued and Overrated?*, AM. AFF., Spring 2018, at 4.

crowdfunding. Of course, inflation undermines the effectiveness of the safeguards built into the Accredited Investor net-worth and income tests.

6. Congress, the Commission and Public Need Data on the Current Use of Transaction Exemptions

Unfortunately, Congress, the Commission and the public lack important data on the current use of transaction exemptions. Without this information, Congress, the Commission, and the public cannot evaluate whether exemptions from SEC registration – *even as currently structured* – adequately protect investors.

A. Types of Data

We would recommend that the Commission work with state securities regulators to conduct a comprehensive survey of the existing use of transaction exemptions and to make the results publicly available. Among the type of data the Commission should collect are the following:

1. *Volume of Issuances:* What is the aggregate annual volume of transactions using a particular exemption? How is this changing over time?

2. *Nature of Issuers:* What is the size of issuers (by assets and number of shareholders) using the exemption? What percentage of issuers using an exemption are Exchange Act reporting issuers?

3. *Nature of Offerees and Purchasers:* Who are the investors being offered and sold securities under that exemption?

4. *Disclosures:* What information is being given to investors?

5. *"Underwriters":* Are issuers using an exemption engaging a placement agent or other party to sell the securities or act effectively as an underwriter? How are those parties being compensated? To what extent are broker-dealers involved in transactions and the markets for these securities?

6. *Returns/Losses:* What is the distribution of returns to investors from issuances under a particular exemption?

7. *Fraud, enforcement actions, and non-compliance:* What is the incidence of fraud or at least reports of fraud for companies using the exemption? What is the extent of non-compliance with exemption requirements? The Commission should check the identities of issuers and parties involved in the sales process against parties named in securities litigation (public and private, civil and criminal) and SEC, FINRA, and state enforcement actions.

8. *Resales:* What is the level of resales/secondary market trading for securities issued under a particular exemption? What is the timing for those trades, *i.e.* how soon are they occurring

post-issuance? This would help the Commission and the public determine the extent to which resale restrictions under a particular exemption are being subverted and the design of the exemption is being undermined. At the same time, this data would show the extent of liquidity in secondary markets. Comparisons on spreads, commissions, and other fees between private and public secondary markets are also crucial for evaluating the benefits to investors in secondary markets.

We recognize that there may be gaps in the data that can be collected. As one example: Section 4(a)(2) offerings are conducted under a statutory not a regulatory provision, and no filing requirement thus applies.

7. Opening Retail Investments in Private Markets May Tax Regulator Resources

We note that expanding transaction exemptions would also impose costs on regulators, who would have to monitor larger private markets. For any new or expanded exemption, the Commission should consider which regulators – federal or state – would have responsibility for policing issuances and ask whether those regulators – including SEC staff – would have sufficient and sustained resources to perform this obligation. We note that any changes to exemptions that deem securities to be "covered securities" would deprive state blue sky regulators of jurisdiction. Enlarged transaction exemptions would also preclude private rights of action under the Securities Act of 1933. The SEC Staff might face significant pressure to police alone a much wider and less well-lit private market beat.

8. Private Markets Can Pose Financial Stability Concerns

We note that expanding transaction exemptions has other consequences, including for systemic risk and prudential regulation. For example, many of the securities, including mortgage-related collateralized debt obligations, at the heart of the global financial crisis were issued or traded under exemptions from registration. The resultant lower levels of disclosure meant that investors in these instruments, investors in financial institutions exposed to these instruments, and regulators all had less information about the risks of these securities as they metastasized. The disclosure that comes with securities registration and public markets plays a vital role in providing "market discipline" for financial institutions and markets.

9. Transaction Exemptions Should Be Carefully Structured to Promote Migration of Capital to Public Markets

If public companies and public markets create positive externalities, as we have seen, securities regulation should be crafted with a view toward encouraging or even requiring firms to go public. The JOBS Act of 2012[28] illustrates the difficulty of achieving the correct balance. Although it included provisions expressly designed to encourage companies to go public, overall it appears to

[28] *See* Jumpstart Our Business Startups Act ("JOBS Act"), Pub. L. No. 112-106 (2012).

have had the opposite effect, as it simultaneously loosened restrictions on the trading of private securities and the requirement for firms to go public based on their number of shareholders.[29]

This suggests that Congress and the Commission may need to take more aggressive action to usher firms into the public markets. Such measures might include tightening the asset size or shareholder threshold in Section 12(g) of the Securities Exchange Act of 1934, or making existing securities registration exemptions available to an issuer only for a fixed time period.

Conclusion

The signatories have differing views on the details of regulation of both public and private offerings. However, we believe that the Commission needs to consider the propensity of private offerings to divert capital away from public markets and the benefits of public markets that might be thus compromised. Changes to transaction exemptions, particularly transformational changes, should be pursued only after careful collection, dissemination, and analysis of data on the use of existing exemptions and how well these exemptions protect retail investors.

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[29] *See e.g.*, Michael D. Guttentag, *Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules That Require Firms to Make Periodic Disclosures*, 88 Ind. L.J. 151, 173–74 (2013); Michael D. Guttentag, *Protection from What? Investor Protection and the JOBS Act*, 13 U.C. DAVIS BUS. L.J. 207, 234 (2013).

[Institutional affiliations and titles are given for identification purposes only]

Sincerely,

Elisabeth D. de Fontenay
Professor of Law
Duke University School of Law

Erik F. Gerding
Professor and Wolf-Nichol Fellow
University of Colorado Law School

John Coffee, Jr.
Adolf A. Berle Professor of Law
Columbia Law School

James D. Cox
Brainerd Currie Professor of Law
Duke University School of Law

Stephen F. Diamond
Associate Professor of Law
Santa Clara University School of Law

Merritt B. Fox
Michael E. Patterson Professor of Law
Co-Director, Center for Law and Economic Studies
Co-Director, The Program in the Law and Economics of Capital Markets
Columbia Law School

Michael Guttentag
Professor of Law
John T. Gurash Fellow in Corporate Law & Business
Loyola Law School

Colleen Honigsberg
Associate Professor of Law
Stanford Law School

Renee M. Jones
Professor of Law and Associate Dean for Academic Affairs
Boston College Law School

Donald Langevoort
Thomas Aquinas Reynolds Professor of Law
Georgetown University Law Center

Saule T. Omarova
Beth and Marc Goldberg Professor of Law
Director, Jack Clarke Program on the Law and Regulation of Financial Institutions & Markets
Cornell Law School

James Park
Professor of Law
UCLA School of Law

Jeff Schwartz
Professor of Law
S.J. Quinney College of Law
University of Utah

Andrew F. Tuch
Professor
Washington University School of Law

Urska Velikonja
Professor of Law
Georgetown University Law Center