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SECURITIES LAW'S DIRTY LITTLE SECRET

Usha Rodrigues*

Securities law's dirty little secret is that rich investors have access to special kinds of investments—hedge funds, private equity, private companies—that everyone else does not. This disparity stems from the fact that, from its inception, federal securities law has jealously guarded the manner in which firms can sell shares to the general public. Perhaps paternalistically, the law assumes that the average investor needs the protection of the full panoply of securities regulation and thus should be limited to buying public securities. In contrast, accredited—i.e., wealthy—investors, who it is presumed can fend for themselves, have the luxury of choosing between the public and private markets.

This Article uses the emergence of new secondary markets in the shares of private companies to illustrate the above disparity, which has long characterized the world of investment access. First, focusing narrowly on these markets reveals their troubling potential effects on the venture capital world, a vital source of startup funding. More broadly, these new secondary markets bring to light the stark contrasts in investing power and access that have always been securities law's dirty little secret: by making it easier for accredited investors to wield their special privilege, the new markets just make the disparity of investment access more obvious. For example, after Facebook's initial public offering, it was widely reported that accredited investors had been buying shares of the high-profile company in the three years before it rather disastrously went public—at which point the big money had already been made.

Thus, the increased transparency that the secondary markets bring to the world of private investment makes our overall securities law newly vulnerable to a fundamental critique: government intervention has created an investing climate that lets the rich get richer, while the poor get left behind. The Article acknowledges elements keeping the current system in

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place, explaining the current inequality of investor access by way of public choice theory: regulators and companies alike favor the status quo. Viewed from the perspective of the little guy, however, inequality in investment access may prove less defensible and ultimately less tenable. I suggest a modest fix: letting the general public participate in the private market via mutual fund investment, something it currently cannot do.

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INTRODUCTION

F. Scott Fitzgerald wrote, "[The rich] are different than you and me." Apocrypha has it that he once remarked as much to Ernest Hemingway. "Yes," Hemingway is said to have replied, "they have more money." The dirty little secret of U.S. securities law is that the rich not only have more

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money—they also have access to types of wealth-generating investments not available, by law, to the average investor. An investor with enough income or a high enough net worth (an accredited investor\(^3\)) can invest in a private equity fund, for example, or in still-private companies before they go public. The rest of us cannot.\(^4\)

Take Facebook’s initial public offering (IPO). The big news was that, instead of enjoying the usual first-day run-up in stock price, the company’s shares “wobbled,” closing up only 0.6 percent from the $38 offering price—a disappointing return, particularly since Facebook’s IPO was the most ballyhooed in recent memory and the largest U.S. technology company IPO of all time.\(^5\) Its stock plunged 13 percent the next trading day; recriminations and lawsuits swiftly followed, largely centered on the conduct of the investment banks that underwrote the offering and on the delays and logjams in first-day trading.\(^6\) The not-so-big news, however, was that the seeds for the lackluster IPO were sown long before the last-minute machinations of Facebook’s underwriters or NASDAQ’s technical glitches. The demand for shares had to some extent already been met on the private market. In other words, the real story, as Fortune’s Joshua Brown told readers three months before the IPO, was that “Facebook already went public, you just weren’t invited.”\(^7\)

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3. Rule 506 of Regulation D describes several categories of accredited investors, including certain banks, charitable organizations, and certain high net worth individuals, who may invest in securities that are not registered. 17 C.F.R. § 230.501(a) (2012). Most notably for the purposes of this Article, individuals with a net annual income of over $200,000 or a total net worth of over one million dollars may invest in securities that are not registered, provided that those securities meet the general disclosure requirements of Rule 502. Id. § 230.501(a)(5)-(6).


7. Joshua Brown, Facebook Already Went Public, You Weren’t Invited, CNN MONEY (Feb. 8, 2012, 1:05 PM), http://finance.fortune.cnn.com/2012/02/08/facebook-ipo-numbers/ (“On February 1, Facebook at long last filed its official S-1 document with the SEC, the first step toward an initial public offering (IPO) the company expects to do in the second quarter of this year. Despite this fact that it was widely anticipated, the financial media went absolutely bananas. Facebook was the only subject on television, the radio, the web and in the paper. For a week. But lost in all of this saliva-covered enthusiasm was the fact that Facebook’s de facto IPO had already occurred a long time ago.”).
For three years prior to the IPO, accredited investors could buy into Facebook using two new websites, SharesPost and SecondMarket. These sites have created a national secondary market for private company shares. Investors use these websites to buy shares from earlier investors or employees looking to sell. Some accredited investors bought into Facebook early at remarkably low prices, ranging from $1.11 to $9.82 per share, and enjoyed tremendous returns when the IPO occurred (although the very last investors overpaid relative to the IPO price, with the final private auctions closing above $40 per share).8

So far commentators have paid scant attention to this vibrant secondary market, and the few scholars who have written on the emergence of the private secondary market have treated it as a positive development.9 Commentators have assumed that a more robust secondary market will spark a virtuous cycle: increased liquidity will attract more investment, which will in turn lead to increased liquidity as more investors put more money into more companies.10

Time will tell. Two considerations, however, give me pause about the claimed virtues of this supposedly value-adding development. First, there are costs as well as benefits to providing a “new exit” for venture capital.11 Venture capital, a major source of private funding for startups, is sometimes described as the “smart money”—valuable because of the advice and expertise that accompany its dollars.12 If part of venture capital’s value is the motivation of sophisticated investors to work with a company over time to improve it, then giving them an early exit may do more harm than good. By converting venture capital investment into something akin to an option, secondary markets might decrease venture capitalists’ incentives to nurture and monitor the internal workings of their fledgling portfolio companies. As “dumb money” (as we may term the faceless accredited investors on SharesPost and SecondMarket) replaces the “smart money,” monitoring and nurturing may diminish, while the risk of fraud or mismanagement may in turn go up.13

10. Id. at 21–24.
11. Id. at 27–29.
Second, the connection between the secondary market and capital acquisition is not airtight. Pre-SharesPost accredited investors *directly* contributed to the capital and (at least theoretically) growth of the companies in which they invested. In contrast, the corporations whose shares are bought and sold on SharesPost do not receive a penny of accredited investors' money because it is not the *corporations* that sell shares, but rather early investors and current and former employees with vested stock options. This is a *secondary market*, not a primary market through which a capital-seeking firm itself swaps securities for cash. So the new secondary market offers wealthy investors opportunities closed to unaccredited investors, just like the old regime—but without the direct gains in capital formation that used to accompany accredited investment.

Of course, a vibrant secondary market increases the price that shares will fetch on the primary market; the possibility of resale increases the price of a product. And such gains may offset the losses in expertise described above. Indeed, if rewarding early investors with liquidity causes more angel and venture capital investment, then the changes in the secondary markets will ultimately pay off in increased capital formation. Still, the new money does not flow directly into the company's coffers, as it did under the old accredited investor regime, so it is possible that the new secondary investors are cannibalizing the company's own stock sales.

Additionally, speculation is a zero-sum game, where two parties make a bet on the value of a stock. For every dollar one side gains, the other side must lose. Given that transaction costs must exist on both sides, and that they are higher in the private secondary market than in the public one, the fact that secondary markets by their nature encourage speculative trading may prove a net social cost.

My suggestion thus far has been that the advent of private secondary markets may have upset the traditional balance in securities law by diluting the commitment of venture capitalists and by loosening the connection between capital and investment. Yet these new markets present one more cost, one with ramifications outside the confines of the venture capital

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14. For an explanation of angel investors, see infra Part I.A.1.
world. These secondary markets might appear to the ordinary citizen as nothing more than stock exchanges for the rich, from which the general public is unjustifiably shut out. Because of current regulations, average investors cannot even participate in these markets indirectly by way of mutual funds. Thus, the overall impression may be of an America where those who are already wealthy can cash in on investments that make them even wealthier, while average Joes can only press their noses up against the glass and await an IPO—at which point, as with Facebook, the big money has already been made. There have been reports of such sentiments in the popular press.\(^{16}\) And the perception that the public stock market is for chumps and suckers should not be taken lightly.

The second part of this Article will use these new secondary markets as a prism through which to view the state of securities law—from the novel perspective of the little guy. The new secondary market websites did not create a disparity in investment opportunity; U.S. securities law has always allowed wealthy investors to enter certain markets (including not only the market for private company investments but also private equity funds and hedge funds), while cording off average (retail) investors from the same opportunities. I will argue that the disparate treatment of investors is not the product of sinister conspiracy, but rather an unintended consequence of the original driving force of securities regulation: investor protection.

\(^{16}\) See, e.g., Daniel Gross, Facebook's IPO Already Happened—Several Months Ago on Secondmarket, YAHOO! FIN. (May 21, 2012, 9:44 AM), http://finance.yahoo.com/blogs/daniel-gross/facebook-ipo-already-happened-several-months-ago-secondmarket-134457488.html (“Thanks to SecondMarket, big-shot investors no longer have to wait until an IPO to express their enthusiasm about a company. And that means the froth and pop that used to take place exclusively on the NASDAQ or the NYSE in the opening trading days can now take place weeks or even months before the official IPO. That’s clearly what happened with Facebook.”); Joseph Menn, Insight: Pre-IPO Stock Trading Boom Could Be Scary for Investors, REUTERS (Mar. 15, 2012, 4:39 AM), http://www.reuters.com/article/2012/03/15/us-secondary-trading-idUSBRE8E0CD20120315 (subheading titled “Special Rules for the Rich”); Nancy Miller, Forget Facebook: Why Regular Joes Can’t Invest in the Decade’s Hottest IPO—and Probably Shouldn’t Try, TIME Bus. (Apr. 25, 2012), http://business.time.com/2012/04/25/forget-facebook-why-regular-joes-cant-invest-in-the-decades-hottest-ipo-and-probably-shouldnt-try/ (“The big boys are at the front [of] the line, you are at the back of the line, and there is no middle of the line.”); John Shinal, Easy Facebook Money Already Made, MARKET WATCH (Feb. 2, 2012), http://articles.marketwatch.com/2012-02-02/commentary/31028965_1_ipo-share-facebook-shares-facebook-ipo (“Facebook shares have been trading for several years now on private, secondary markets that cater to wealthy investors. The liquidity that those markets provided is what allowed Facebook to achieve its lofty valuation—and raise a massive amount of capital before it had even filed its first IPO documents. Because Facebook insiders who wanted to sell portions of their stakes—and the investors who were determined to buy them—have already done so, the easy money in Facebook shares has already been made.”); James Temple, Facebook IPO Underscores Shutting Out the Masses, SF GATE (May 22, 2012, 4:00 AM), http://www.sfgate.com/business/article/Facebook-IPO-underscores-shutting-out-the-masses-3575283.php (“Facebook left nothing for the common investor,” Forbes Publisher Rich Karlgaard wrote. “The insider pig pile of (private equity) firms and celebrity Silicon Valley angels took it all. This is a rather new, post-Sarbanes-Oxley fact, and it should make Americans very, very angry.”).
Put simply, the 1933 Securities Act embraced the principle that securities are dangerous and thus should only be sold to the public with lots of protections in place, most notably mandatory disclosure and liability for misstatements. A small exemption was carved out for private offerings, where the purchasers did not need securities law's protections. Securities law's emphasis—then, as now—was on who was permitted to sell securities rather than who was permitted to buy them. Thus, private firms are only able to sell their shares to a subset of the public—the wealthy.

Such segregation in the marketplace may be all to the good. Professor Lynn Stout has argued that the public markets enable an excess of speculative trading. Professor Adam Pritchard has recently argued for abolishing IPOs because of the speculative frenzy they create for retail investors and the meager returns they offer. Modern portfolio theory, which held sway at least before the financial crisis of 2008, counseled that the best investment strategy is buying and holding a diversified portfolio, ideally in a passively managed fund. It cautioned that it is a fool's errand to try to outsmart the market, either by one's self or via an actively managed fund. Indeed, recent evidence suggests that, for all their exclusivity, private equity investments might not regularly outperform the broader stock market after all.

Yet the general public might well benefit if, through mutual funds, they could invest at least a portion of their wealth in private companies, hedge funds, or private equity funds. Modern portfolio theory teaches that moderate exposure to a broad range of investment types, each with a different risk profile, is the safest and surest path to wealth gain.

19. See, e.g., Stephen M. Bainbridge, The Case for Limited Shareholder Voting Rights, 53 UCL A L. REV. 601, 632 (2006); Victor Fleischer, Two and Twenty: Taxing Partnership Profits in Private Equity Funds, 83 N.Y.U. L. REV. 1, 21 (2008) ("Prior to the adoption of portable alpha, modern portfolio theory focused on diversification as the dominant method for managing risk. In its simplest form, modern portfolio theory cautions investors to maintain a diversified mix of stocks, bonds, and cash in order to balance the volatility of their portfolios with the desire to maximize returns. Under this theory, only a small amount of assets would be placed in risky alternative asset classes like real estate, venture capital, buyout funds, and hedge funds.").
21. See Matthew F. Gately, Much Ado About Nothing: An Analysis of the “Accredited Natural Person” Standard, 2008 COLUM. BUS. L. REV. 760, 780–81 ("According to modern portfolio theory, investors can minimize risk by holding a diversified portfolio, which occurs
undeniably risky, investment in private firms offers the potential for high returns; like foreign investments, domestic stocks of large and small publicly traded firms, bonds, and real estate, it has its place in a balanced portfolio. But such investments are currently out of reach for the average investor.

The logical question, and the one this Article will conclude by addressing, is why a democratic political system has allowed such unequal treatment to continue. Public choice theory provides an answer: collective action problems and the SEC’s limited appetite for increasing investor exposure to risky assets has combined to sustain the status quo. Investors are rationally ignorant and apathetic, and regulators’ incentives are skewed against enlarging investment access in an area that (1) offers little for the rent-seeking regulator and (2) could cause average investors to lose their shirts. And so differential investor access has long remained securities law’s dirty little secret.\textsuperscript{22}

Yet times may be changing. The new secondary markets, by broadening the number of investors that can participate in this privileged market, have increased its visibility and could provide the impetus for reform. Additionally, section 201 of the JOBS Act\textsuperscript{23} lifted the prohibition on general solicitation for private companies and funds, while retaining the requirement that only accredited investors may actually invest. This change means that the general public may soon, for the first time, hear advertisements for these once-secretive investments on the radio, TV, and internet—even though they are barred from actually investing. Thus, section 201 further increases the visibility of exotic investments that remain tantalizingly out of reach of the common man. If such visibility increases the pressure for reform, this Article proposes a regulatory change that would allow ordinary investors access, by way of mutual fund-like investments, to the private market.

This Article will proceed in two parts. Part I.A describes traditional private market investment. Next, Part I.B introduces the new secondary markets, explaining how they work and how they have been received in the literature thus far. It then explores the potential problems they present for the venture capital ecosystem. Part II pulls back and reflects on the larger issue of inequality of investment opportunity. After tracing the history of the accredited investor exemption in Part II.A, Part II.B reviews securities

\textsuperscript{22}More specifically, while many people may understand that exclusive entities like hedge funds exist, far fewer realize that access to special private investments may be just out of reach, available to those with incomes within spitting distance of their own. For example, a newly minted attorney at a big firm, both well educated and earning $150,000 a year, was shut out of the secondary market for pre-IPO shares, where her college roommate, now a pediatrician making $200,000 a year, was not.

I. THE WORLD OF PRIVATE COMPANY INVESTMENT

The emergence of the new secondary market created by SharesPost and SecondMarket introduced a new era of accredited investing. To understand this new world, however, we must first understand the old one—that is, the structure within which accredited investing occurred from 1933 until only three years ago. The literature describes the venture capital world as fostering a special kind of innovation, using a model of capital formation much more complex than simply raising money from rich people. Angel investors and venture capitalists bring valuable qualities and contribute skills, expertise, and vigilance to the life of a start-up. In contrast, the new secondary market expands the universe of investors, but more closely resembles a stock exchange than a traditional venture-financing round.

A. The Old World: Investment in Private Companies

Accredited investors, like retail investors, can choose between individual or collective investment opportunities—in other words, they can invest in single companies or in funds. First we will examine cases where accredited investors seek out individual companies. The most prominent example is the angel investor.

1. Angel Investors

There is no fixed formula for starting a new corporation, but the early years of development generally follow a common pattern. Typically, entrepreneurs begin funding their endeavor with their own cash (sometimes coupled with credit card debt), and then turn to “family and friends” for loans or investment via common stock. Angel investors step in next, often providing from $100,000 to $2 million in exchange for company stock, generally on relatively undemanding terms. Companies that

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26. Reports are mixed as to whether angels receive common equity or, like VCs, preferred stock (which takes priority over common stock). Compare id. at 1422 ("[T]he
survive and demonstrate promise then seek additional investments from venture capital funds. Typical infusions of venture capital (VC) money average between $2 and $10 million.\textsuperscript{27} If a company is able to attract several rounds of VC investment, it is often acquired or goes public, earning the founders and private investors a return many times their original investment.

Angel investing thus occurs near the beginning of the start-up’s life cycle, at the point when outside investment is first sought. Angel investors are wealthy individuals, often former entrepreneurs,\textsuperscript{28} who aim to provide seed capital to start-ups. Angel investors are a diverse group, defined loosely as “wealthy individuals who are not family members or personal friends of a company's founders.”\textsuperscript{29} Many angels are experienced entrepreneurs; others are rich heirs, doctors, or lawyers.\textsuperscript{30}

Angel investments are risky; one study found that almost two-thirds of them lose money.\textsuperscript{31} However, the same study estimated an average return of 10 percent per angel investor,\textsuperscript{32} indicating that overall angel investing is still profitable. Why is that? First, angels often spend considerable time monitoring their investments.\textsuperscript{33} Angel investing is a largely local phenomenon. Close to the action, angels can act as an “informal sounding board,”\textsuperscript{34} offering “seasoned advice on and empathy with the many difficulties faced in advancing an early-stage venture.”\textsuperscript{35} Second, angels tend to find investment opportunities via a “network of trust”—through friends, angel groups, and knowledgeable business contacts.\textsuperscript{36} A shared social network, coupled with attentive monitoring, may make it easier for angels to separate good investments from bad ones on the front end, and less likely that the start-up entrepreneurs will take advantage of them on the

\textsuperscript{27} Ibrahim, supra note 25, at 1416.
\textsuperscript{28} Id. at 1408.
\textsuperscript{29} Cable, supra note 26, at 115. Angel networks and funds now exist, as well—about 300 as of 2009. Id. at 117. These groups may act in a more venture capital-like manner than the traditional angels. Id.
\textsuperscript{30} Id. at 116.
\textsuperscript{31} Id. at 128.
\textsuperscript{33} Id. at 130.
\textsuperscript{34} Id.
\textsuperscript{35} Ibrahim, supra note 25, at 1419.
\textsuperscript{36} Cable, supra note 26, at 131.
back end, due to the reputation costs they would suffer in a close-knit investment community.  

2. Venture Capital Funds

Just as retail investors often join forces by investing in mutual funds, accredited investors can pool capital with their fellows in VC funds, private equity funds, and hedge funds. While these funds all share the same basic structure and compensation scheme, they differ in character and investment focus. My primary concern is with VC funds, but I will first briefly describe private equity and hedge funds to help explain why I am setting them to one side—at least for now.

Venture capital funds focus on start-ups and normally take only a stake in the portfolio company. In contrast, private equity funds generally target mature private or public firms, using debt (the “leverage” in a leveraged buyout) to take over a firm in toto. Private equity managers aim to use their expertise and a disciplined plan to reduce expenses and improve operations to generate the cash needed to pay off the debt that paid for the company. Their goal is to sell the improved or “leaner and meaner” company for a profit—or to break it up and sell the pieces. Hedge funds—in contrast to both private equity and venture capital funds—tend to specialize in short-term trading. These investment vehicles focus neither

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37. See id.; see also Ibrahim, supra note 25, at 1431 (“Angel investing is highly localized, relationship-driven, and industry-specific. Angels like to invest in start-ups where they know either the entrepreneur or the substantive area (e.g., biotechnology or e-commerce), and preferably both.”).

38. Accredited investors are not the only investors in such funds; pension funds, university endowments, and insurance companies all invest in them as well. William A. Sahlman, The Structure and Governance of Venture-Capital Organizations, 27 J. FIN. ECON. 473, 488 (1990). But for the purposes of this Article, the crucial point is that if an individual wants to invest in such funds qua individual, he or she must be accredited.

39. All three are usually structured as limited partnerships, with the manager serving as the general partner and the investors as limited partners. See Andrew A. Schwartz, The Perpetual Corporation, 80 GEO. WASH. L. REV. 764, 806 (2012). Broadly speaking, all use incentive compensation of “two and twenty,” where fund managers receive a modest 2 percent of assets under management, and 20 percent of the profits, perhaps over a given threshold or “hurdle” rate. See Fleischer, supra note 19, at 3.


41. See Brian Cheffins & John Armour, The Eclipse of Private Equity, 33 DEL. J. CORP. L. 1, 13 (2008) (“Since most of the ‘free cash flow’ (essentially operating cash flow minus capital expenditures) will be committed to debt service, management will be forced to adhere to strict, results-oriented financial projections.”).

42. See Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. PA. L. REV. 1021, 1084 (2007) (“For the short-term trading horizon of hedge funds to generate a short-term investment outlook for hedge fund managers, the stock market must suffer from myopia: that is, it must undervalue long-term investments relative to short-term investments.”) (emphasis omitted).
on the start-up nor on the mature company, but instead typically invest in "publicly traded stock, commodities, and related derivatives."

Venture capital funds are the most relevant for the purposes of this Article because they focus on the kind of venture-backed start-up companies—such as Facebook, LinkedIn, and Groupon—that have so far dominated trading at SharesPost and SecondMarket. Hedge funds and private equity funds, however, also remain enclaves for the wealthy. Thus, if our guiding principle involves skepticism about special rules for the rich, we should keep hedge funds and private equity funds in view. In Part II.D, I will return to these sorts of investment vehicles; however, for now we will set them to one side.

When an established VC firm such as Sequoia or Benchmark organizes a new fund, it asks accredited investors for a minimum commitment, with most of the money to be contributed via "capital calls" as the fund needs more money. The fund is structured as a limited partnership, with the manager serving as the general partner and the accredited investors, together with institutional investors such as endowments and pension funds, serving as limited partners. Venture capital investors entrust their money to fund managers for a considerable period of time, typically ten years.

The VC fund’s manager then seeks out "portfolio companies" (i.e., companies in which it wants to invest). Generally VC funds make several rounds of investment in these companies, often joining with other VC funds to make a series of investments at $2 to $10 million per round in exchange for preferred stock, which receives priority over common stock in certain situations.

Venture capital-backed companies are more likely to succeed than non-VC-backed firms, not only because of the capital VCs provide, but also because they carefully select and monitor their investments. Venture capitalists almost always are allotted a seat on the board. Like angel investors, VCs are often local and sector specific. They have expertise

43. Cable, supra note 26, at 113.
44. See Rob Garver, Preparing for Private Equity, BANK INVESTMENT CONSULTANT, Nov. 2007, at 45, 46.
45. Sahlman, supra note 38, at 490.
47. Ibrahim, supra note 25, at 1411.
49. Accord Dana M. Warren, Venture Capital Investment: Status and Trends, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 1, 12 (2012) ("Venture capital investment almost always involves significant participation in and oversight of each of the portfolio companies by the venture capital professionals. As a result, simple logistics makes venture capital investment an inherently local, or at most regional, activity.").
that can help a young company navigate key decisions; they have connections that help with recruiting skilled managers; and they have experience that helps channel and discipline the energy of often-young entrepreneurs. Conventional wisdom says that venture capital is "smart money" that has special value for a budding organization. The allure of investing in venture capital funds is clear: venture funds have reportedly offered returns of approximately 16 to 20 percent a year, far more than what an investor can expect from the public market.

Although the literature has emphasized differences between angels and VCs, they share four important characteristics. First, they are both illiquid investments. Venture capital funds generally invest in portfolio companies looking for an exit after five to seven years, with an eye toward returning money to the funds’ accredited investors at year ten. Because angels invest earlier in a company’s life cycle, they have an even longer path to liquidity. Second, both angels and VCs are engaged investors. Knowing their money will be tied up for years, they carefully sift through potential investments before committing their capital. Third, both angels and venture capitalists bring knowledge and expertise to their investments, spending considerable time and energy monitoring the performance of the start-ups in which they invest. Finally, these investments are profitable. While angel investment has an element of “for-profit philanthropy,” angel investors achieve results “in the ballpark” of the high-yield venture capitalists.

50. See Ibrahim, supra note 25, at 1411.
53. Since venture capital is a private industry, reliable figures on returns are hard to come by. Moreover, lower performing funds tend to underreport. See, e.g., Marco Da Rin et al., A Survey of Venture Capital Research, in 2A HANDBOOK OF THE ECONOMICS OF FINANCE 573, 621 (George Constantinides et al. eds., 2013), available at http://www.nber.org/papers/w17523.pdf?new_window=1 (“Phalippou and Gottschalg (2009) find that funds that do not report cash flow data in ThomsonOne have a success rate in terms of IPO or acquisitions of portfolio companies that is five percentage points lower than for funds that report such data.”); Deborah Gage, Venture Capital’s Secret—3 Out of 4 Start-Ups Fail, WALL ST. J., Sept. 20, 2012, at B1 (“Venture capitalists ‘bury their dead very quietly’ . . . . “They emphasize the successes but they don’t talk about the failures at all.””). Other estimates include 17 percent or 14.1 percent. Dar Rin et al., supra at 79–81.
54. See Ibrahim, supra note 25, at 1438 n.169 (“Angels typically have longer exit horizons than their venture fund counterparts and thus the capital they provide is termed patient capital.” (quoting Jeffrey Sohl, The Early Stage Equity Market in the USA, 1 VENTURE CAPITAL 101, 111 (1999))).
55. Id. at 1409.
56. Cable, supra note 26, at 129.
Overall, U.S. start-ups are often cited as a model for investment-driven innovation.57 Both within and outside the United States, governments have expressed a desire to foster the next Silicon Valley and have looked to the venture capital model for inspiration.58 Mindful that this sector of the economy is a critical contributor to overall growth, we turn next to the new private secondary markets. These markets differ in important ways from the venture capitalists and angel investors. Faceless internet transactions replace the careful negotiation, monitoring, and control rights of the venture capitalists. In assessing the fairness and sustainability of these new markets, gains achieved by broadening the scope of the investor class should be weighed against their accompanying costs.

B. The New Secondary Market for Private Shares

In 2009, two different companies began matching buyers and sellers of private company stock online. For now these two firms, SecondMarket59 and SharesPost,60 dominate the market,61 although some competitors have already emerged, while others are rumored to be close to launching.62 This market is significant, generating $9.3 billion in trades in 2011 alone.63

Now-public venture-backed companies like Facebook, Twitter, Groupon, and LinkedIn traded heavily on these sites.64 While most of sites' traffic comes from classic start-ups, some established private companies—such as Cargill, Levi's, Publix, Trader Joe's, and In-N-Out Burger—generated significant interest on SecondMarket in 2011.65 Listing companies

57. See Steven J. Markovich, U.S. Entrepreneurship and Venture Capital, COUNCIL ON FOREIGN REL. (June 5, 2012), http://www.cfr.org/united-states/us-entrepreneurship-venture-capital/p28433 ("Entrepreneurship is a primary contributor to job creation and sustainable economic growth, and policies affecting innovation and startup financing have wide ramifications."); cf. Eric Pfanner, Maker of Angry Birds Shows Way for European Start-Ups, INT'L HERALD TRIB., May 18, 2012, at 17 ("In general, . . . start-ups in Europe often struggle to get off the ground, finding it harder to raise money at the critical early stages than their American counterparts.").
58. See Cable, supra note 26, at 107 ("In many respects, current public policy reflects [an] enthusiasm for startups.").
62. See id.
64. See Rusli & Lattman, supra note 61.
typically have a valuation of "$100 million or more, hav[e] $10 million or more of annual revenue, and hav[e] been in business for 5 or more years." 66 In other words, they are fairly large and mature private companies. Some companies permit wide-open trading. Others authorize sales only during designated windows of time. 67

SecondMarket, founded in 2004, began to facilitate trades in the private securities secondary market in 2009. 68 It operates as something of an illiquid asset bazaar, allowing accredited investors to buy interests in exotic asset classes such as auction-rate securities, bankruptcy claims, and wine. 69 SecondMarket’s current model requires companies to disclose two years of financials before their shares can be sold 70 and permits the company to exert control over who may deal in its shares. Its website explains:

SecondMarket will work with the company to identify who should participate as a buyer or seller in the transaction. The company has full control over approving the buyers and sellers. The company may limit buyers to only existing investors, buyers already known to the firm, buyers SecondMarket introduces or a combination of these individuals. The company also identifies which sellers are allowed to participate, whether it’s ex-employees, outside investors or certain current employees. At the end of the selection process, the company has confirmed exactly who is participating in the program. . . . The company can set any limitation on the level of seller or buyer participation, including defining the maximum percentage of ownership possible for any buyer, the minimum and maximum limit on the number of shares sold, etc. 71

The timing of sales is also at the company’s discretion: “A company may decide to conduct a one-time liquidity event or schedule liquidity events on a quarterly, semiannually, annually or other frequency. This decision is typically based upon the company’s objectives and anticipated liquidity needs in the future.” 72

68. Ibrahim, supra note 9, at 36. For an excellent history of SecondMarket, see Teitelbaum, supra note 67.
72. Id.
SharesPost, in contrast to SecondMarket, focuses solely on sales of private company stock. It does not involve the company to the extent that SecondMarket does—although the company must waive any transfer restrictions applicable to the shares that are sold. Rather than relying on company-provided financial information, SharesPost provides potential buyers access to privately prepared research reports on firms whose shares are traded. It also offers a “Venture-Backed Index” as a barometer to help investors value companies. SharesPost initially attempted to position itself as a passive bulletin board and resisted registering as a broker-dealer, but eventually succumbed to the SEC’s pressure to do so.

While each company strives to differentiate itself from the other, for the purposes of this Article their similarities outweigh their differences. Both websites require that buyers be accredited investors. Each employs a verification process to ensure that the buyer is accredited and that the company approves the sale, since the proposed trade nearly always involves shares subject to transfer restrictions.

The accredited investor exemption requires that issuers take reasonable steps to prevent purchasers from

73. See Davidoff, supra note 70. Interestingly, the different disclosure approaches SharesPost and SecondMarket are taking create a version of Paul Mahoney’s suggestion in The Exchange As Regulator, 83 VA. L. REV. 1453, 1458–63 (1997). SecondMarket requires issuer disclosure, while SharesPost relies on third-party reports. Presumably investors will favor one venue over the other, and shares of the same firm will trade at a premium or discount depending on whether investors value the information provided more or less.


76. Teitelbaum, supra note 67 (“Weir needles his East Coast rival. ‘We come out of a Silicon Valley mind frame, using technology to solve the problems,’ he says. ‘They are brokers with phones.’”).

77. SecondMarket has a registered broker to verify these details and shepherd the process along. Id. An “operations specialist” makes sure the transaction complies with antifraud and money laundering rules. Id. SharesPost requires prospective buyers to submit their own information certifying their accredited status. A broker then reviews the information and contacts the customer to confirm that information. If the broker determines that the prospective buyer qualifies as an accredited investor, then he or she can view or use the trading platform. They then reconfirm their status at the time of any purchase. See A SharesPost Primer on Secondary Market Securities Law, SHARESPOST (2012), https://welcome.sharespost.com/system/resources/BAhBIShQGZmSSJdMjAxMi8wNC8xM C8wMS80Ni8zNC8yMi8U2hhcmVzVzUG9zdF9Qcm1lZXM5b25kYXJ5X01hcmtld F9TZWNIcml0aWVzOxh18zLjE3LjEyLnBkZG1yY2BkVU/SharesPost%20Primer%20on%20Secondary%20Market%20Securities%20Law%2019.12.pdf; see also Dennis K. Berman, My Dead Grandma, Facebook Investor, WALL ST. J., Apr. 12, 2011, at C1. Berman used his dead grandmother in order to test the site’s screening. It worked—for a little while. SharesPost’s primer was posted April 2, 2012. It is unclear what the vetting process was prior to then, but the new process seems designed to help prevent the “dead grandmother” problem—which was, as Berman acknowledges, caught rather swiftly by SharesPost. See id. SecondMarket also must analyze and obtain waivers for any contractual restrictions on share transfer that may exist.
selling in violation of the registration requirement.\textsuperscript{78} Thus, because Rule 144 permits resale only after the seller has held the shares for at least a year,\textsuperscript{79} the companies require that sellers demonstrate share ownership for that period of time. From press accounts, it seems that buyers likewise agree to restrictions with regard to resale.\textsuperscript{80}

Because the market is private, information about sellers and buyers can be hard to come by. SecondMarket has released data on the identity of its sellers for 2011: 79.3 percent of sellers were ex-employees, 11.1 percent were current employees, 3.7 percent were “investors,” 0.4 percent were founders, and 5.5 percent were “other.”\textsuperscript{81} Darian Ibrahim, author of the first law article on these markets, conducted interviews with some of the market participants, and, while acknowledging that most current sellers are entrepreneurs or employees, he notes that a growing number of venture capitalists are beginning to sell their shares as well.\textsuperscript{82} While companies themselves may eventually offer shares for sale via these websites,\textsuperscript{83} they have not yet done so to any significant degree.

So much for sellers. The next natural question concerns the identity of the buyers. According to SecondMarket, in 2011, 27.2 percent of its buyers were individuals; the remaining 72.8 percent were institutional investors (of which 29 percent were “family offices,” an undefined term).\textsuperscript{84} Anecdotal reports indicate that VC funds are buying most of the shares sold on the secondary market. For example, Elevation Partners is reported to have invested between $90 and $210 million in Facebook on the secondary market.\textsuperscript{85} Even so, a substantial portion have been acquired by wealthy individuals.

Although accredited status will get an investor in the door, the sites also require a hefty commitment to make a deal happen. The minimum sales

\begin{itemize}
\item \textsuperscript{78} 17 C.F.R. § 230.502(d) (2012).
\item \textsuperscript{79} Id. § 230.144(d)(ii). The holding period is six months for reporting companies under the Exchange Act. Id. § 230.144(d)(1).
\item \textsuperscript{80} Joe Light, Facebook’s Early Buyers Burned, Too, WALL ST. J., June 7, 2012, at C1 (“Buyers generally can’t unload their shares until Facebook employees are permitted to sell in November.”); see Shayndi Raice et al., Facebook Targets $96 Billion Value, WALL ST. J., May 4, 2012, at A1 (“Mr. Landis bought shares of Facebook on the secondary market for $31 to $32 a share over the past year and agreed not to sell the shares for six months after the IPO.”).
\item \textsuperscript{81} SecondMarket’s 2011 Year End Private Company Report, supra note 65.
\item \textsuperscript{82} Ibrahim, supra note 9, at 16–19.
\item \textsuperscript{84} SecondMarket’s 2011 Year End Private Company Report, supra note 65.
\item \textsuperscript{85} Michael Arrington, Source: Elevation Partners Got About 1% of Facebook for $90 Million, TECHCRUNCH (Apr. 5, 2010), http://techcrunch.com/2010/04/05/source-elevation-partners-got-about-1-of-facebook-for-90-million/; Dan Primack, supra note 13.
\end{itemize}
price for a transaction initiated on SharesPost is $25,000.

SecondMarket has a minimum of $100,000 per transaction. Other transaction fees can add up. SecondMarket charges 3 to 5 percent per transaction, split evenly between buyer and seller. SharesPost charges the greater of $5,000 or 5 percent. An opinion from a lawyer stating that the sale qualifies for an exemption from registration costs around $2,500. Buyer and seller each pay an escrow agent $1,500 to ensure that both shares and money are in hand and an exchange can occur. Companies may impose separate minimums of their own; Facebook at one point imposed a minimum requirement of 10,000 shares for a sale. Companies also may impose their own additional fees for processing the sales, ranging from $2,500 to $6,000 dollars per transaction.

In summary, accredited status may qualify investors to participate, but they must commit a sizable amount of money, beginning at around $30,000, in order to actually invest. Investors may choose between an exchange offering information from the company (SecondMarket) and one offering third-party reports (SharesPost). These secondary markets are far removed from the traditional venture capital world of negotiated face-to-face deals, engaged investing, and control rights to protect future interests. Buyers give the sellers money, nothing more.

C. Prior Literature on the Secondary Markets

The literature on venture capital is rich and vast. In contrast, few legal scholars have written on the new secondary markets, no doubt in large part because of their novelty. Darian Ibrahim is optimistic about the opportunities they hold as a "new exit" for venture capital. Venture capital funds, as we have seen, seek to return investors' money after a limited time,

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88. Frequently Asked Questions for Sellers, supra note 86 ("What are the costs of facilitating a transaction on SharesPost?").


91. MacMillan, supra note 90.

generally ten years. Thus the ability of VC funds to exit, or cash out of their investments, is of critical importance to their success. Traditional VC exits took place by means of an IPO or a sale of the portfolio company (a trade sale). Trade sales may turn a profit for VCs, but Ibrahim characterizes the IPO as the "gold standard" exit mechanism.94 Yet the IPO is a relative rarity today.95

Commentators have bemoaned a "liquidity gap" that has arisen as the domestic IPO market has dried up.96 Private markets have become increasingly important as the median age of companies backed by venture capital at IPO rose to 8.3 years in 2011 from 4.3 years in 1999.97 According to Ibrahim, this liquidity gap poses a problem for the entire venture capital economy. Most importantly, it creates an illiquidity discount—investors pay less on the front end for their shares because a near-term IPO is less likely down the road.98

Ibrahim lauds the prospect of venture capital funds using the secondary markets as a new exit, filling the liquidity gap. He sees several potential benefits: First, venture capitalists will pay more for investments if they know there is a tangible way out, thus reducing the illiquidity discount.99 Second, the exit will improve corporate governance.100 In the old regime, venture capitalists were between a rock and a hard place, locked in an illiquid investment with no exit right,101 and facing the clamoring of their own limited partners for a payout from the ten-year fund. Thus, they were at the mercy of managers who underperform or self-deal.102 In the new secondary market, they can sell to outside VCs, gaining liquidity for their own investors and leaving the shares in the hands of investors with a fresh exit clock.103 So the argument goes that, thus armed with a credible exit

94. Ibrahim, supra note 9, at 11-12.
96. Ibrahim, supra note 9, at 11 ("When traditional exit markets are strong, such as the IPO market of the late 1990s, investor lock-in in venture capital is not severe because IPOs happen quickly. When traditional exit markets are weak, however, as in recent years, investor lock-in is severe.").
97. Light, supra note 80.
98. Ibrahim, supra note 9, at 14–15.
99. Id. at 22. Ibrahim uses the term "illiquidity premium," but “discount” is the more accepted term. See, e.g., Schwartz, supra note 39, at 792.
100. Ibrahim, supra note 9, at 24–25.
102. Ibrahim, supra note 9, at 7, 24.
103. See id. at 20 ("[D]irect market buyers, themselves funds with investors to answer to, come into start-ups with a fresh exit clock. Therefore, while the VC’s fund may be set to expire, forcing it to seek even a suboptimal exit, direct market buyers essentially start over in waiting for a traditional exit. As long as traditional exits for winning companies are simply delayed, rather than gone altogether, direct market buyers will reap their spoils." (emphasis omitted)).
power courtesy of the new secondary market, the venture capitalists will be less vulnerable to agency costs on the part of the entrepreneur.104

Jose Miguel Mendoza and Erik P.M. Vermeulen have taken a similarly rosy view of the new secondary markets.105 They too emphasize the need for liquidity and voice concern that the current dearth of IPOs will discourage entrepreneurship.106 They call the new secondary markets an “essential ingredient” of the new venture capital cycle and argue that intrusive regulation of them may kill the goose that laid the golden egg.107 They emphasize that “the buyers of shares on these private secondary marketplaces are not ordinary retail investors, but rather sophisticated players with prior and detailed knowledge of firms’ activities.”108 However, as Part II.B.1 illustrates, Mendoza and Vermeulen overstate their case. Buyers on SharesPost and SecondMarket are not guaranteed to be “sophisticated players with prior and detailed knowledge” of the firms they buy. They are merely guaranteed to be rich.

To date only Elizabeth Pollman has failed to join the chorus rejoicing over these markets.109 Pollman worries that information asymmetries may arise in these markets because buyers and sellers may have vastly different levels of information and potential conflicts of interest.110 She is particularly troubled by the potential for insider trading in the new markets111—a concern I, too, share, but which she has already ably addressed.112 In the next section, I turn to more structural challenges these new markets pose to the traditional VC ecosystem.

D. Concerns

The emergence of the private secondary market constitutes a critical, if not transformative, development in securities law. I am, however, far more reluctant than others to hail this innovation as an unadulterated good. Like Pollman, I worry about information asymmetries and insider trading.113 But my concerns run much deeper. In this section I raise questions regarding both the role this market might play as venture capital’s “new exit” and the ramifications of making it easier for accredited investors to trade in private equity. Stepping even farther back, I consider the challenge

104. Id. at 3.
106. Id. at 13.
107. Id. at 16.
108. Id. at 22.
109. See Pollman, supra note 66, at 182.
110. Id. at 210–12.
111. Id. at 216–21.
112. Id. at 222–35.
these markets might pose to our current securities law regime, regarding who deserves special access to these kinds of investments—and why.

1. Concerns Regarding the Function of Venture Capital

As a prefatory matter, we should acknowledge that it is unclear to what extent VCs now do or later will actually make use of the new exit option Ibrahim, Mendoza, and Vermeulen applaud. Currently, employees and former employees are the main sellers on SharesPost and SecondMarket. Even so, in 2011, 3.7 percent of SecondMarket’s sales were by “investors,” and this number may grow. In short, the existing evidence is thin, but let us assume that VCs will in fact increasingly make use of this new exit option. In my view, it is not at all clear that this development would be good. Indeed, I have four concerns about how this manner of exiting investment may affect the functioning of our markets and our economy.

First, I am not convinced that there is a “liquidity gap” or, if so, that it is a problem. It is certainly true that there are fewer IPOs, and perhaps it is true that acquisitions are second-best exit mechanisms for the VCs. Ibrahim notes that “when the IPOs of the Internet boom period recently dropped out of the ten-year measure of VC performance, average returns plummeted from thirty-four percent to fourteen percent despite a healthy number of trade sales.” These numbers do not sound too horrible: a 14 percent return looks pretty good in today’s investing climate and is certainly high enough to attract investors. Moreover, boom-and-bust cycles are endemic to the industry—the IPO “window” is notoriously short and can open and close quickly. Some suggest that “the lack of an IPO market has caused venture capitalists to avoid financing some of the more far-reaching and risky ideas that have no obvious Fortune 500 buyer.”

To the extent that this quotation indicates that VCs are being more careful and selective, it is not necessarily a bad thing. In order to view the

114. See supra note 81 and accompanying text.
115. See id. Ibrahim cites one observer who stated: “Very recently, however, entrepreneurs and employees were selling only fifty percent by dollar amount and seventy percent by transactions volume, meaning that VCs are increasingly turning to secondary sales for their exit woes.” Ibrahim, supra note 9, at 17. Another source stated that “strategic buyers are also entering the market, but buying ‘only what they know.’” Id. at 20. A third source told Ibrahim that “late-stage VCs often buy their preferred shares from early stage VCs. Id. This interviewee claimed that ‘sixty to seventy percent of [later-stage VC financing rounds] have a secondary component to them.” Id. In other words, late-stage VCs buy some of their shares from the start-up’s treasury and some from existing investors.” Id. at 19–20.
development as a negative, one requires a theory of net societal payoff for funding super-risky investments. Maybe such a theory exists. My own sense, however, is that funding such investments may frequently involve throwing someone's money down the drain. And the someone who turns out to be at risk may be the very accredited investor through whom the supposedly beneficial exit option is exercised.

Second, reports of VC's vulnerability vis-à-vis entrepreneurs seem greatly exaggerated. To begin with, risks of opportunism exist on both sides, as Ibrahim acknowledges. More importantly, as Part I.A.2 described, VCs carefully screen their investments on the front end and insist on numerous contractual controls to protect themselves. Of particular significance, they stage investments, bargain for board representation and control rights, and secure covenants that give them veto power over major transactions. Indeed, the generally accepted view is that venture capitalists are far more likely to put the screws to the entrepreneur, than the other way around.

Ibrahim advances the idea that VCs are more vulnerable at the beginning of a start-up's life, when they have fewer seats on the board. But this early stage, when the exit option would be most valuable, is when the shares will be least liquid on the secondary market. As discussed above, the new secondary market is generally for mature, late-stage private companies. A major investor looking to liquidate thousands of shares of an early stage start-up would flood the market, thus automatically depressing the price. Moreover, the exploited VC would face a clear lemons problem, raising questions as to the motivation for selling. Buyers may well be reluctant to invest in companies that experienced VCs are looking to exit. What's more, SecondMarket's current model gives the company the right to veto any upcoming sales, thus nullifying any potential investor exit power (unless they bargain up front for the right to sell—we have yet to see evidence of such contractual provisions, but they may come). In short, it is unclear how useful the VC exit option would even be.

Ibrahim is right, however, to point out that in a mature private company there may be conflicts between what entrepreneurs and investors want—for example, because of different contractual payouts, perhaps sometimes founders will favor a trade sale whereas VCs will want to wait for an IPO. Allowing dissenting entrepreneurs or investors to exit via a stock sale may provide a good way to mitigate these conflicts and bring on board

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119. Ibrahim, supra note 9, at 25.
121. Ibrahim, supra note 9, at 24.
123. Ibrahim, supra note 9, at 28–29.
more like-minded investors. At this point, exit may well be meaningful and useful, although generally more so to the founders than to VCs.

But even seemingly win-win exits may impose costs, which leads to my third point: VC illiquidity provides significant benefits. The prospect of capital lock-in makes investors look before they leap and, once committed, actively manage and monitor their investment. And the investors who are locked in are the “smart money”—repeat players with deep knowledge of the industry and management principles, who pride themselves on being able to nurture young companies and guide them on the road to success.

Ibrahim concedes that the new secondary market poses a threat to these “high powered performance incentives”: Founders, employees, and investors alike will be less committed to the organization if they can cash out. He responds that initial reports indicate that VCs sell only a portion of their holdings and thus remain motivated to nurture the firm even after they enter the secondary market.

Yet the problem seems to remain. VCs are exiting either because they are unhappy with the company or because outside constraints force them to liquidate against their druthers. In the former case, the preferred exit would be a complete one, handicapped in practice by the lemons problem outlined above. In the latter case, a VC fund that reduced its investment in a firm by half would presumably (and rationally) proportionately diminish the attention it paid to that investment. Moreover, the prospect of easy exit might make it less selective when considering whether to invest in the first place. Replacing the VC’s “smart money” are the faceless investors of the secondary market. Some of these are highly sophisticated venture capitalists; others have nothing to recommend them but wealth.

The prospect for muted incentives on the part of employees is likewise troubling, although more defensible. For example, the new secondary market gives employees the ability to liquidate a portion of their stock holdings that would otherwise be illiquid, especially given the seven-to-eight-year delay they would otherwise experience in the current economy. Such power would be valuable, especially to those employees who live in expensive areas such as Silicon Valley, and would not necessarily lessen their incentive to work hard for the company. The prospect of early sales may attract better talent, who might otherwise be reluctant to risk tying their fate to a start-up. Furthermore, Ibrahim observes that most sellers are ex-employees or forgotten founders whose interests might not align with the company’s any longer. Current employees typically sell only some shares, and they cannot sell at all until a year after their options vest. Nevertheless, there are costs as well as benefits to providing employees with this increase in liquidity. Stock options must be valued at the market

124. Id. at 30.
125. Id. at 30–31.
126. Id. at 31.
127. Id.
price, and a board must take into account its company’s rising stock price on the secondary market when assigning a value to options. Rising secondary market valuations are thus a double-edged sword. While current employees undoubtedly benefit from being able to cash out a portion of their stock holdings, prospective employees face the unwelcome prospect of a richly valued stock grant. When an IPO or a trade sale finally occurs, the share price may fall below the secondary market price, or the stock option strike price, as happened with Facebook.\textsuperscript{128} The result is that employees who come late to the party may find their stock options “underwater”—i.e., worthless. And so they might not accept the invitation of employment at all.

One might object that, because of transfer restrictions, the company retains a veto right over proposed sales and would not authorize them if they conflict with its best interests. Yet the company’s decisions are made by its individual agents, and these agents might have private reasons to permit or even encourage a secondary market for company shares. Most notably, they may be looking to cash out their own stock, even if such sales are detrimental to the firm as a whole.

Fourth, these sales might represent foregone capital for the company. In a 2011 interview, Barry Silbert, SecondMarket’s founder, claimed: “The money that we are freeing up is being reinvested in other venture-backed start-ups—and creating jobs . . . . This market we’re building is critical to the whole capital-formation process.”\textsuperscript{129} Yet any money being “freed up” is early investor money that may be—but is not necessarily—used to fund other start-ups. The company receives no money from secondary market sales, where third parties merely sell shares to one another. All of the gain goes to early investors and employees. Indeed, these sales could come at the expense of the company, since demand met on the secondary market might mean foregone opportunities to raise capital.

On the other hand, secondary markets obviously foster capital markets, as we see with the national exchanges for public stock. The question is whether the increase in liquidity the new markets afford outweighs the potential for cannibalization of the primary market and muting of high-powered incentives. In other words, the value of the exit option turns on how many potential VC investors hold back because they fear they will have to wait too long to exit if IPOs and acquisitions remain the primary exit mechanisms. In other words, how elastic is the venture capital market?

The question is empirical in nature, and in due course the data may provide an answer. For now, what is clear is the foregone opportunity: VCs that buy on the secondary market do not buy in the primary market. Even if they are investing in both simultaneously, a possibility Ibrahim suggests, start-up companies may well be missing out on potential

\textsuperscript{128} See supra note 8 and accompanying text.

\textsuperscript{129} Teitelbaum, supra note 67.
investment while lessening the commitment of existing investors and employees because they can exit, or at least know they can exit.

Behind all of these concerns is the sense that the old VC model fostered private-firm capital raising, but in a constrained manner to individuals who had specialized knowledge of the industry and the firm. The bargain might be an implicit one, but it nonetheless existed. The new secondary markets upset the terms of the deal by letting accredited investors, whose only qualifications are wealth and the willingness to invest considerable sums, buy out earlier investors.

2. Concerns Regarding the Accredited Investor Exemption Generally

Thus far I have discussed potential problems that the new secondary market may pose for the traditional venture capital model. These new secondary markets are an exciting new development in securities law, and the preceding section departed from the trend in the nascent literature by describing some of the costs that they might impose.

But the emergence of this market raises a more far-reaching concern—that the private and public markets have now grown radically disconnected and unequal. The American shareholder base has long been large and diverse, in contrast to the pattern in Europe, where corporations are owned primarily by banks and wealthy families.130 While most American investors own shares through mutual or pension funds, as Professor Zachary Gubler points out, “underlying these funds are still retail investors: plumbers, teachers, doctors—people of all stripes who, either through their retirement plans or their non-retirement savings, invest in these companies.”131 In contrast, the private market, with its promise of outsized returns, is the exclusive preserve of the accredited investor. We risk entering—if we have not already entered—an investing world where the common perception is that the real money is made in the private market. The JOBS Act’s lifting of the prohibition on general advertising for private investments will only add to the perception of an exclusive market that exists just for the wealthy.

This perception may not accord with reality132: the little-guy investor may well be better off foreclosed from the private market. But average investors, despite well-intentioned and sage advice to the contrary, continue to flock to actively managed funds and otherwise seek to beat the market. Professor Lynn Stout has recently described what she terms “optimism-driven speculative trading.”133 This Article takes no position on the advisability of such trading, but accepts it as a given: those who participate

131. Id. at 800.
132. See supra note 20 and accompanying text.
in financial markets are inherently, even if wrongly, convinced that they can or will profit. Such optimists will find less than palatable the notion that the law keeps them out of certain markets.134

To the extent this perception of being shut-out of a valuable market exists, we face a major problem. One of the SEC's mantras is that ordinary investors should enjoy a "level playing field"135 when investing in the stock market. Usually this phrase comes up to explain the evils of insider trading or selective disclosure by companies to analysts, who pass on the information to favored clients.136 Sometimes the expression surfaces in the context of flash trading, where investors with supercomputers exploit their ability to trade faster than the average investor in order to turn a profit.137 In each case, the harm is to ordinary investors not privy to certain information or technology that would give them an edge. The harm to the market, and to the overall economy, from the public perception that public markets are a tilted playing field is nearly impossible to measure, but it is a matter of fundamental concern.138

As difficult to measure, and perhaps just as costly, is the perception that the stock market is for the schleps too poor to get in on the real action. If Americans believe that the real profits are being made by the rich, then even a "level" public stock market would offer only an equal opportunity to earn a pittance compared with what can be made elsewhere. In other words, average investors who brave the public markets confront not a stacked deck but a penny-ante game. The law reserves the high-stakes tables for the rich.139

134. Alternatively, investors may seek the basic satisfaction of finding the "next Microsoft." Stephen J. Choi & A.C. Pritchard, Behavioral Economics and the SEC, 56 STAN. L. REV. 1, 15 (2003). Either way, the fact that current securities law denies them access to a particular asset class would prove frustrating.


138. The counterargument is that these transactions make market prices more accurate and the overall market more efficient, to the benefit of all, even the little guy. The truth of argument and counterargument is irrelevant to my intuition. The point is that a perception exists that a level playing field is an important regulatory goal. See Jesse M. Fried, Insider Abstention, 113 YALE L.J. 455, 456 (2003) ("Although academics still debate the economic desirability of insider trading, the consensus among the American public, Congress, and the SEC is that insider trading is 'unfair' and erodes investor confidence in the market.").

139. One objection to this concern is that reports of private equity returns, like Mark Twain's death, may be greatly exaggerated. See, e.g., Da Rin et al., supra note 53, at 81 ("Overall we note that while different studies obtain somewhat different estimates of the net returns, there is an emerging consensus that average returns of VC funds do not exceed market returns."). Yet such investments nevertheless offer valuable exposure to a unique asset class, with a different risk profile, from the typical public equity investment. Moreover, even if the sector overall does not outperform the market, successful private equity firms have a tendency to continue to outperform their benchmarks (as mutual funds
Gubler terms this phenomenon the "crowding out" of the retail investor: "Thus, as the private securities market expands, the retail investor is crowded out, and the model of democratic capitalism that has defined the American corporate landscape for nearly a century is upended." Gubler points out two costs that stem from the growth of the private market. First, retail investors are shut out of a whole class of investment and lose out on the benefit of diversifying into this risky, but profitable, terrain. More is at stake than not making as much money as the rich, however. Fundamentally, this disparity in investment opportunity increases the financial inequality that many analysts criticize. Elizabeth Pollman voices similar concerns about shutting small investors out of investment in smaller, growth companies. She quotes finance writer Felix Salmon: "To invest in younger, smaller companies, you increasingly need to be a member of the ultra-rich elite.

The Facebook IPO raises an alternate, less troubling possibility—that investing in hot private companies may be a mark of cachet rather than an investing strategy. Felix Salmon raises this scenario, where investing in private companies is yet another means of conspicuous consumption:

In reality, however, it's increasingly looking as though shares in private tech companies are a bit like fine art prices: a place for the rich to spend lots of money and feel great about owning something very few other people can have. The minute they become public and democratic, they lose their cachet. And a lot of their value.

If buying these companies is the equivalent of owning a Rolls-Royce or a Birkin bag, perhaps the secondary market is no big deal—although it is worth noting that even a janitor or police officer with a few thousand dollars to spend can buy a Birkin bag. There is no minimum net worth required for purchase. In contrast, the government forbids them from buying private shares.

140. Gubler, supra note 130, at 800–01.
141. See id.
142. See TIMOTHY NOAH, THE GREAT DIVERGENCE: AMERICA'S GROWING INEQUALITY CRISIS AND WHAT WE CAN DO ABOUT IT 177–78 (2012) ("[A]mong the half of all Americans who are in the market, only about one third have stock holdings worth $7,000 or more. . . . Eighty-one percent of all stocks are owned by the top 10 percent; 69 percent by the top 5 percent; and 38 percent by the top 1 percent.").
143. Pollman, supra note 66, at 239–40.
145. See Light, supra note 80 ("Scoring early shares of Facebook carried a measure of cachet.").
There is one unalloyed benefit to these secondary markets: they have generated greater efficiency and transparency. Secondary markets in private equity have existed for years, but they have been ad hoc and largely accidental.147 It was hard for interested buyers to find willing sellers, and vice versa.148 Furthermore, each buyer had to conduct her own due diligence, without the benefit of information on prior sales or any semblance of a market price.149 Each individual transaction might entail a great deal of negotiation.150 While perhaps not as efficient as the public market, the new secondary private market makes buying and selling these kinds of shares more feasible for more people with greater information and lower transaction costs.

Perhaps just as importantly, the new secondary markets moved these deals out of backrooms and into the light of the internet.151 No longer is getting in on the “ground floor” of the next hot company a function of whom you hang with in Silicon Valley. In this sense, the new secondary markets do level the private market playing field. Yet the field has been leveled only for the small minority of investors—namely, accredited investors—who are permitted to play under the rules of the game. In short, the playing field may be more level than it used to be for the haves. The have-nots, however, are still shut out. And they are shut out in a starker and more visible way than ever before.

Transparency is synonymous with virtue in the modern age, so it seems downright perverse to describe it as problematic. Yet the secondary markets do more than give their participants a clearer sense of how individual companies are valued and lower their transaction costs when investing. They also provide a newfound visibility into the division of the investing world into haves and have-nots. Average Joes already know they cannot invest in hedge funds, VC funds, and private equity funds. But the means of making such investments and the criteria the funds employ to screen potential investors is mysterious. In contrast, to use SharesPost or SecondMarket all you need is an internet connection—and enough money.

147. See Light, supra note 80 (“Secondary markets have existed for years, with behind-the-scenes brokers hooking up buyers and sellers. [SharesPost/SecondMarket] attempts to provide more transparency to private transactions and a more uniform process of buying and selling.”).
148. Ibrahim, supra note 9, at 21.
149. See id.
150. Id. (“[S]ubstantial negotiation might ensue over the purchase price and other transaction details.”).
151. Gennine Kelly, Private Exchanges in ‘Dialogue’ With SEC: President SharesPost, CNBC (Dec. 29, 2010, 3:20 PM), http://www.cnbc.com/id/40842540/Private_Exchanges_in_Dialogue_With_SEC_President_SharesPost (“Essentially what we’ve done is taken all those same securities laws that have always protected investors buying private company securities and we just wired them into a web interface—a 2.0 type platform that allows a certain amount of efficiently [sic], transparency and scale to what used to be a very backroom industry where private companies shares would trade.” (quoting Greg Brogger, President of SharesPost) (internal quotation marks omitted)).
Couple that with the possibility of private investment opportunities being advertised to a general public that cannot meet the requirements to buy them, and what emerges is a much clearer window into the private investing world than the public has ever known before.

The new transparency may not be problematic at all, if you believe that we should no longer sweep securities law's dirty little secret of differential investor treatment under the rug. At the very least, it may be time to reassess the balance we have struck between investor protection, capital formation, and equality of access.

II. DISPARITY IN INVESTMENT ACCESS TODAY

This part attempts to work a species of Copernican revolution in securities law by examining the question of securities sales from the buyer's perspective. A brief history of the accredited investor exemption reveals the basic problem: securities regulation regulates the offerings that firms make to the public. By creating a "private offering" exception, where the only rule is not to commit fraud, and by further allowing one aspect of the exception to turn on the qualities of the buyer, the law set the stage for differential investor treatment. So much for the doctrine. In terms of theory, scholars have focused on justifying the imposition of mandatory disclosure on public firms; relatively few have grappled in any systematic way with the existence of private offerings, let alone justified them. What results is a gap in our understanding of how securities law works in practice. In the name of investor protection, investors have been harmed by being sidelined. After laying this groundwork, this part describes the harm the general public suffers when shut out of the private markets, and proposes a relatively easy fix: private market mutual fund-like investments. It offers a public choice explanation for the failure of such a market to arise to date, and closes with the suggestion that perhaps the advent of the new secondary markets might spur change. Private market mutual funds could replicate some of the beneficial monitoring venture capital used to provide.

A. How We Got Here: A Short History of the Accredited Investor Exemption

The new secondary markets hinge on the accredited investor concept—that wealth alone can serve as a safe harbor against the buffeting winds of the private market. The accredited investor exemption is a relatively new idea, the product of decades of struggle to determine who should fall outside the reach of the securities laws. The original 1933 Securities Act distinguished two different types of securities offerings: public and nonpublic. Public offerings had to be registered with the Commission and meet imposed disclosure rules that have only grown more elaborate over

152. See supra note 23 and accompanying text.
time. In contrast, transactions “not involving any public offering”\textsuperscript{153} (i.e., private offerings) were exempt from registration, on the theory that “there is no practical need for [the Security Act’s] application or . . . the public benefits are too remote.”\textsuperscript{154}

In \textit{SEC v. Ralston Purina Co.}, the Supreme Court first articulated how to identify those who have no practical need for the Security Act’s protection.\textsuperscript{155} The Court held that “[a]n offering to those who are shown to be able to fend for themselves is a transaction ‘not involving any public offering.’”\textsuperscript{156} Exemption, according to the Court, turned on the lack of “knowledge of the offerees,” including “the need of the offerees for the protections afforded by registration.”\textsuperscript{157} The Court further hinted that to negate disclosure duties, offerees would need “to have access to the kind of information which registration would disclose.”\textsuperscript{158} While seemingly straightforward, \textit{Ralston Purina} raised questions of application: When are investors able to fend for themselves? What should courts look to in making this determination? How important is the investor’s overarching “knowledge” of the securities market as opposed to having access to company-specific information?

Issuers, the SEC, and the judiciary all struggled for decades with the inherent subjectivity of trying to determine what makes investors able to “fend for themselves.” For example, Rule 146 focused on whether an investor “could afford to hold unregistered securities for an indefinite period, and whether, at the time of the investment, he could afford a complete loss.”\textsuperscript{159} There were three requirements: (1) that an issuer have “reasonable grounds to believe that each offeree was a sophisticated investor,” with wealth or specialized knowledge tending to demonstrate that sophistication, (2) that the issuer have “reasonable grounds to believe that a purchaser either could evaluate the investment’s risks and merits himself, or had consulted a financial advisor and was able to bear the financial risks,” and (3) that each offeree needed to have “access to the same kind of information that a registration statement would have provided.”\textsuperscript{160} As Professor C. Edward Fletcher observed, “Rule 146 thus required that all

\textsuperscript{154} H.R. REP. NO. 73-85, pt. 2, at 5 (1933). Section 4(1) of the Securities Act accordingly exempts from registration “transactions by any person other than an issuer, underwriter, or dealer” and “not involving any public offering.” 15 U.S.C. § 77d(1)-(2).
\textsuperscript{155} 346 U.S. 119, 126–27 (1953).
\textsuperscript{156} \textit{id.} at 125.
\textsuperscript{157} \textit{id.} at 125–27.
\textsuperscript{158} \textit{id.} at 127.
offerees be sophisticated or wealthy, [and] that actual purchasers be sophisticated or consult a financial advisor."\(^{161}\)

The SEC switched gears in 1982. Its new Regulation D moved from a regime that required both access to information and sophistication to one that required investors to have access to information and "either sophistication or wealth."\(^{162}\) The "sophistication" requirement hewed to the spirit of past exemption law and regulation. Sophisticated purchasers (limited to no more than thirty-five per company) must have, either on their own merits or by way of an intermediary (termed the purchaser representative), "such knowledge and experience in financial and business matters that [they are] capable of evaluating the merits and risks of the prospective investment."\(^{163}\) While the sophistication test may still sound subjective, Rule 508 (enacted a few years later) creates a safe harbor for issuers as long as the offering was made in good faith.\(^{164}\)

But Regulation D’s real innovation came with its grant of a special status to the “accredited investor,” who was qualified to participate in private offerings by virtue of wealth alone.\(^{165}\) This development set the stage for the formation of today’s secondary market. Congress, as part of the Small Business Investment Incentive Act of 1980, first introduced the idea of the accredited investor, defined as "any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe."\(^{166}\) Drawing on this new delegation of authority, the SEC in 1982 promulgated Rule 501, which defined accredited investors to include natural persons with a net worth of $1,000,000 or income over $200,000 over each of the last two years, with a reasonable expectation of the same in the current year.\(^{167}\) For the first time an investor could participate in private offerings simply because of high income or net worth.\(^{168}\)

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161. Id. at 1123.
162. Id. (emphasis added). Rule 242 replaced Rule 146 for a matter of two years but was largely an interim step on the road to Regulation D, so this brief history of the accredited investor will not describe it.
163. Id. (internal quotation marks omitted).
164. See 17 C.F.R. § 230.508 (2012) (requiring that a “good faith and reasonable attempt was made to comply with all applicable terms, conditions and requirements” of the relevant exemption).
165. Although there are eight categories of accredited investors, this Article will focus on natural persons because my interest lies in the perceptions of inequality between ordinary (natural person) investors and their more wealthy counterparts.
168. As an interesting historical aside, the original Regulation D as promulgated in 1980 included a “heavy hitter” or “big ticket” qualification for accredited investor status. If investors purchased at least $150,000 worth of the security being offered, they could qualify as accredited investors. In 1988, the SEC eliminated this path to accredited investor status. See Mark A. Sargent, The New Regulation D: Deregulation, Federalism and the Dynamics
The accredited investor exemption has remained in place ever since. The SEC expanded the definition to take account of spousal earnings in 1988, providing that joint income of over $300,000 for the past two years, with a reasonable expectation of the same in the current year, would qualify either spouse as an accredited investor. On the other hand, the SEC in 2010 effectively raised the net worth requirement—in keeping with new limits imposed by Dodd-Frank—by excluding the value of an investor’s primary residence and calculating as a liability any mortgage indebtedness to the extent that the home is “underwater.” This reform responded to the concern that “one million dollars isn’t what it used to be”—an idea to which I will return later.

That, in a nutshell, is the story of the accredited investor exemption. I, for one, do not see in this history a sinister plot to favor the wealthy and keep the rest of us in our place. Rather, the accredited investor appears to be the natural outgrowth of a focus on the different risks that private companies pose to different categories of investors. Our securities laws ban private firms from the public markets. From the beginning, however, we begrudgingly allowed these private companies access to a subset of investors for whom “there is no practical need” for protection. Regulators and judges struggled over the years to articulate how best to define and describe that subset, moving from individuals who can “fend for themselves” or have “knowledge” and “access” to registration-like information (Ralston Purina), to “sophisticated investors” with access to the same kind of information registration would provide (Rule 146).

In 1982, the SEC introduced its new bright-line rule for defining accredited investors. Issuers no longer needed to make subjective assessments of the sophistication of a potential investor. If investors had a high enough net worth or yearly income, then they were eligible for the broad swath of investment opportunities denied the retail investor. While

of Regulatory Reform, 68 Wash. U. L.Q. 225, 277 (1990). Still, its original inclusion may be significant as we consider what kinds of investors should enjoy access to private companies. If a sizable investment makes for salutary monitoring, perhaps the willingness to plunk down a large sum should once more grant investing hopefuls access to private companies.


170. That is, to the extent that the mortgage exceeds the estimated fair market value of that residence. Dodd-Frank Wall Street Reform and Consumer Protection Act § 413(a), 15 U.S.C. § 77b(a)(11) (Supp. V. 2011). Section 413(b) of Dodd-Frank also directed the SEC to regularly review the accredited investor definition. Id. § 77b(b). An early version of Dodd-Frank, the Restoring American Financial Stability Act of 2010, initially proposed raising the limit to $2.3 million in net worth or $450,000 in income. See Michael L. Monson, The Evolution and Future of the Accredited Investor Standard for Individuals, 23 Utah B.J., no. 6, 2010, at 36, 38; see also Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 412 (2010); Seth Chertok, A Detailed Analysis of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 6 Va. L. & Bus. Rev. 1, 38 (2011). After substantial opposition, the Senate version of the Stability Act was only amended to no longer allow individuals to include their primary residence in their wealth calculations, but leave the income and wealth thresholds otherwise untouched.
wormholes remained for the average investor, because of their risks, issuers have used them sparingly.

None of this involved a conspiracy to keep the average Joe out of the private market. Instead, the law reflected an ongoing regulatory effort to strike a policy-sensitive balance, coupled with the emergence over time of a wealth-based bright-line rule. This evolution from standards to rules comport with themes that permeate our law. While standards offer the advantage of nuance, they also carry inevitable difficulties in application. Bright-line rules offer ease in application but may be underinclusive, overinclusive, or both. The choice between standards and rules thus involves tradeoffs that are well documented in the legal literature.

171. For example, under Rule 504 an issuer can sell up to $1 million in securities in a twelve-month period to unaccredited investors as long as it delivers disclosure documents that comply with the requirements of the state in which the security is registered, and delivers those documents to all purchasers. 17 C.F.R. § 230.504(b)(2) (2012). Rule 505 allows issuers to sell up to $5 million in securities in a twelve-month period to up to thirty-five unaccredited investors, as long as (1) purchasers are informed that they will receive restricted securities that cannot be sold for six months or longer without registration, (2) nonaccredited investors receive disclosure documents equivalent to those used in registered offerings, and (3) an independent public accountant certifies the issuer’s financial statements. Id. § 230.505(b)(2)(i)-(ii) (general requirements for offerings up to $5 million); id. § 230.502(b)(1)-(2) (describing the type of information that must be furnished to unaccredited investors under Rules 505 and 506); id. § 230.502(b)(2) (noting that issuers that do not have to file Form 10-K must have their financial statements audited and that issuers that do have to file Form 10-K must provide one of their annual reports, information on form 10-K, or information on form S-1 to investors); id. § 230.502(b)(2)(i) (requiring that issuer advise all purchasers of resale restrictions). Rule 506 imposes no dollar cap and permits up to thirty-five unaccredited investors. However, it requires that (1) all nonaccredited investors have sufficient financial and business sophistication to be able to evaluate the merits and risks of the prospective investments, (2) the nonaccredited investors receive disclosure documents equivalent to those used in registered offerings, (3) purchasers be informed that they are receiving restricted securities, and (4) an independent public accountant certifies the issuer’s financial statements. Id. § 230.506(b)(2) (allowing no more than thirty-five unaccredited investors, and requiring that all unaccredited investors be sophisticated); id. § 230.502(b)(1)-(2) (describing the type of information that must be furnished to unaccredited investors under Rules 505 and 506); id. § 230.502(b)(2)(vii) (requiring that the issuer advise all purchasers of resale restrictions). None of these exemptions permit general solicitation or advertisement. Regulation A also permits offerings to unaccredited investors but is rarely used. Rutheford B Campbell, Jr., Regulation A: Small Businesses’ Search for “A Moderate Capital,” 31 DEL. J. CORP. L. 77, 82–83 (2006).

172. Willa E. Gibson, Is Hedge Fund Regulation Necessary?, 73 TEMP. L. REV. 681, 690 (2000) (suggesting that hedge funds rarely solicit unaccredited investors); Henry Ordower, Demystifying Hedge Funds: A Design Primer, 7 U.C. DAVIS BUS. L.J. 323, 335 (2007) (suggesting that since the wealth requirements for accredited investor status are relatively modest, unaccredited investors are not attractive to issuers); Wallis K. Finger, Note, Unsophisticated Wealth: Reconsidering the SEC’s “Accredited Investor” Definition Under the 1933 Act, 86 WASH. U. L. REV. 733, 745, 766 (2009) (noting that hedge funds rarely issue securities to unaccredited investors because the cost outweighs the revenue gained).

173. See, e.g., Duncan Kennedy, Form and Substance in Private Law Adjudication, 89 HARV. L. REV. 1685, 1685 (1976); Margaret Jane Radin, Presumptive Positivism and Trivial Cases, 14 HARV. J.L. & PUB. POL’Y 823 (1991); Pierre Schlag, Rules and Standards,
Although not driven by malicious intent, this regulatory evolution had the effect of creating a world divided into investing haves and have-nots.\textsuperscript{174} To date most critiques of the accredited investor concept have focused on the vulnerability of the haves, questioning their sophistication and ability to truly "fend for themselves."\textsuperscript{175} My concerns about this body of law lie mostly elsewhere, but a quick review of the standard criticisms reveals both the extent of the danger these scholars have highlighted and the extent to which securities literature has ignored the sidelining of the retail investor. Perhaps this omission is unsurprising. U.S. securities law starts from the premise that private corporations pose serious risks. As a result, the average investor must be protected from them. As the next section reveals, with two exceptions, no one questions the baseline premise.

**B. Securities Literature**

The securities law literature has almost completely ignored the problem of differential investing the accredited investor exemption created. This section first describes scholarly treatments of the accredited investor exemption, which have mostly argued that the threshold is too low. It next moves to examine the reasons behind scholars' failure to address the problem of differential investor access.

1. Criticism of the Accredited Investor Concept

The SEC's equation of wealth and sophistication has attracted much attention and much objection. The difficulty is that the SEC's new definition of favored investors is both under- and overinclusive with respect to the underlying purposes of federal securities law. First, the definition omits many individuals who in fact do have the financial sophistication and knowledge to weigh the risks and fend for themselves. However, while a few commentators acknowledge in passing the underinclusiveness problem, they have spilled more ink on the overinclusiveness problem. Rich, they say, does not mean sophisticated. Or even smart. For years commentators have pointed out the risks private placements pose to the "rich, accredited,

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\textsuperscript{175} See, e.g., Felicia Smith, Madoff Ponzi Scheme Exposes "The Myth of the Sophisticated Investor," 40 U. BALTIMORE L. REV. 215, 253 (2010) ("What the Madoff fraud seemingly exposed was an astonishing lack of critical diligence by numerous sophisticated investors. Given the vast sums invested with Madoff, these investors had every incentive—and the means—to look after their own interests.... Nonetheless, a number of them seemed unable or unwilling to fend for themselves." (citations omitted)).
undiversified" investor.\textsuperscript{176} Professor Manning Gilbert Warren observed in 1984:

Experience indicates that the wealthy often do not have the sophistication to demand access to material information or otherwise to evaluate the merits and risks of a prospective investment. Consequently, they frequently fail to seek professional advice, particularly if they are focusing on the immediate tax consequences of an investment. Furthermore, the net worth, income, and amount of purchase criteria do not assure that, in fact, the investor is able to bear the risk of losing the invested funds. For example, an investor accredited solely by virtue of net worth may base his net worth computation on liberally appraised illiquid assets or on the assets of a spouse. An investor accredited solely by income . . . may actually be insolvent at the time of purchase.\textsuperscript{177}

Professor C. Edward Fletcher likewise observes that "the SEC assumes either that wealthy investors are always sophisticated or that they, no matter how naive, do not need the protection of the 1933 Act's registration provisions."\textsuperscript{178}

Professors Donald Langevoort and Robert Thompson have pointed out that "we have plenty of anecdotal evidence of institutional and wealthy individual investors fending for themselves poorly."\textsuperscript{179} Professor Howard Friedman argued that the rich, accredited, and undiversified are vulnerable and poorly protected by the securities laws.\textsuperscript{180} Professor Felicia Smith described the "myth of the sophisticated investor," as revealed by Bernard Madoff's Ponzi scheme.\textsuperscript{181} Madoff operated a hedge fund, and accordingly his investors were (or were supposed to be) accredited investors.\textsuperscript{182} But being accredited investors did not save them from financial disaster. And it is not just Bernie Madoff. Professor Jennifer Johnson points out that "[m]ost promoters involved in these questionable investment schemes sell

\textsuperscript{176} Howard M. Friedman, \textit{On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation}, 47 OKLA. L. REV. 291, 291 (1994). Larger private placements are available under Rule 144A to "qualified institutional buyers"; that is, any entity of the following types that owns and discretionarily invests, whether for its own account or the accounts of other qualified institutional investors, in the aggregate at least $100 million in securities unaffiliated with the entity: insurance companies, registered investment companies, licensed small business investment companies, state and local employee benefit plans, ERISA plans, certain trust funds, business development companies, nonprofit companies, corporations (other than banks), partnerships, business trusts, and registered investment advisors. 17 C.F.R. § 230.144A(a)(1)(A)-(I) (2012). Because more than accredited investor status is needed to invest in such offerings, they are outside the scope of this Article.


\textsuperscript{178} Fletcher, supra note 160, at 1124.


\textsuperscript{180} See Friedman, supra note 176.

\textsuperscript{181} Smith, supra note 175, at 215.

\textsuperscript{182} Id. at 233; see also Pierre-Louis, supra note 20, at 46.
securities pursuant to the so-called private placement exemption of the federal securities law, which is only available for sales to [accredited] investors."

In the end, however, these perennial criticisms of the accredited investor have failed to gain traction. Protecting the haves—even the victims of Bernie Madoff—just does not play well in the media or in the legislature. Langevoort and Thompson offer a practical and plausible justification: "in a world of thin regulatory resources, larger and relatively more sophisticated investors are lower priority" because they have larger, more diversified portfolios and, if all else fails, the wherewithal to sue. Even if they cannot fend for themselves, they can afford to lose the money:

The ability to absorb losses may actually be the real explanation for what we mean by investors who do not need the protection of the securities laws—they can and do suffer from issuer concealment, but rarely drastically. As such, they can more easily be told simply to learn from the experience, not repeat the mistake, and seek damages if fraud can be proven.

The SEC has not been entirely blind to the risks posed to the unsophisticated accredited investor and, indeed, it made a regulatory push in 2007 to raise the threshold for qualifying as an accredited investor. In doing so, it noted that the driving force behind the original definition in 1982 was "ensuring that only such persons who are capable of evaluating the merits and risks of an investment in private offerings may invest in one." The Commission further noted that, between inflation and the rapid increase in housing values, "many individual investors today may be eligible to make investments . . . that previously may not have qualified."

The SEC floated two separate reforms aimed at raising the threshold, but both failed to take hold.


184. Langevoort & Thompson, supra note 179, at 363.


187. Id.

188. First, the SEC proposed a new "large accredited investor" standard that would apply to hedge funds. Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 8828, 72 Fed. Reg. 45,116, 45,119 (proposed Aug. 10, 2007). Individuals would need $2.5 million in investments (as opposed to net worth) or an annual income of $400,000 (or $600,000 with one's spouse) to qualify as large accredited investors. Id. Second, it proposed an alternative "investments-owned" standard, under which $750,000 in investments would qualify a person as accredited investor, apart from separate qualifying tests based on net worth and annual income. Id. at 45,123–24. The SEC also proposed indexing all investment thresholds for inflation, by tying all dollar-amount thresholds to an index of publicly available price data from the Department of Commerce, with such changes to first be made on July 1, 2012. Id. at 45,126. These proposed changes went nowhere,
On the other side of the equation, hardly any scholars have criticized the accredited investor concept as being underinclusive. Indeed, I have come across only two commentators who have even suggested that there might be a problem, and both focus solely on the area of hedge funds. Jasmin Sethi proposes a new role for securities regulation—expanding investor opportunity. She argues that, as in the areas of housing, education, and civil rights, it may be appropriate for the government to intervene in financial regulation in order to expand the opportunities of unaccredited investors. While making intriguing points, Sethi grounds her argument in empirical research on investor behavior and limits her focus to access to hedge funds. Furthermore, she was serving as an SEC attorney at the time of the article's publication—not in the mainstream of the legal academy. In contrast, Houman B. Shadab is a professor at New York Law School. In 2008, he offered a similar argument for granting retail investors the access to hedge fund investment, based on the harm caused by not having a fully diversified portfolio. Thus, while both articles buck the prevailing trend and argue for expanding investor access, neither ventures beyond the realm of hedge funds to ask broader questions about what should define the contours of the private market.

Given the lack of criticism of the status quo, perhaps it is unsurprising that scholars have not felt the need to justify accredited investors' special status in any detail. As described above, some scholars defend the current system against charges of overinclusiveness by arguing that, even if wealth is a weak proxy for sophistication, at least accredited investors (if diversified) can bear the loss. But I have been unable to find a justification of the accredited investor exemption that might placate an unaccredited investor aggrieved at being sidelined.

2. Glossing over the Public/Private Divide in the Scholarship

In some sense, it is puzzling that legal scholars have largely ignored the "dirty little secret" of the different rules that apply for the private market. From another perspective, it is not surprising at all. As the prior section has shown, securities law doctrine has always focused on the firm—the seller—rather than the buyer (except in the context of investor protection). The literature has likewise focused on firms rather than investors. The classic presumably because the fallout from the financial crisis diverted SEC attention to other, more pressing matters.

190. Id. at 793.
192. The most notable exception is a proposal by Stephen Choi that advocates moving to regulate investors rather than issuers. Stephen Choi, Regulating Investors Not Issuers: A Market-Based Proposal, 88 CALIF. L. REV. 279, 310 (2000). However, Choi advocates
justifications for mandatory federal securities regulation turn on the desirability of requiring firms to disseminate knowledge; they do not by their terms allow for a class of investors that somehow would not benefit from such knowledge. In other words, they largely ignore the existence of private markets entirely. The divide between public and private markets is therefore remarkably undertheorized, although Donald Langevoort is a notable exception. His recent work with Robert Thompson has explored the limits of "publicness" in today's markets.

The private markets are private because the companies may sell their shares without submitting to initial registration with the SEC under the Securities Act and continual reporting under the Exchange Act. The traditional economic justifications for mandatory registration and disclosure are that with unregulated markets: (1) investors are not sufficiently protected from stock price manipulation and fraud; (2) information is underproduced unless universally required because it is a public good (a variant being that it is naturally underproduced because, although firms would ideally disclose information that investors want, they abstain because they know competitors will profit from any secrets they reveal); and (3) the danger lurks that managers will self-deal with the corporation to enrich themselves at the corporation's expense—palm off corporate shares on unsuspecting investors and then make a quick getaway.

The problem with these arguments is that they apply just as easily to the private market as the public one—indeed, they apply to any market in which there is significant trading. If information on companies being traded is a valuable public good, why not have all companies register their shares and issue periodic reports? If agency problems are a concern, why not have all companies disclose related-party transactions? But we have made a different regulatory choice; instead, mandatory disclosure requirements apply to the public markets alone. Federal regulation of the private market is limited to the antifraud Rule 10b-5. The existence of a private market where disclosure rules do not apply must indicate that, despite the economic justifications above, the costs of mandatory disclosure are only justifiably imposed when certain other conditions exist.

One logical way to draw the line is to mandate that firms go public when the number of investors is so great that the benefits of mandatory disclosure formally creating a hierarchy of investors, limiting unsophisticated investors' options even further than the current regime.

193. See Langevoort & Thompson, supra note 179.
194. Id.
outweigh its costs. In other words, an easy delineation between public and private might be that, once a company's stock has more than a certain number of investors, then to avoid costly duplication of investigation and negotiation on the part of each individual investor, disclosure should be mandatory. Yet a mixture of congressional and agency actions makes reliance on mere number of investors impractical.\footnote{199}{Although section 12(g) of the Exchange Act provides that companies with over 500 shareholders of record are subject to many of its disclosure requirements (and conventional wisdom has it that this requirement explains why Google and Facebook went public), the SEC counts shareholders "of record" narrowly. Langevoort, supra note 185, at 1068–69. Section 501 of the JOBS Act increased the record-holder threshold from 500 persons to 2,000 persons or 500 persons who are unaccredited investors. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012).}

A better approach might be to consider the difference between public and private transactions as hinging on whether the market is primary or secondary. The secondary market is where the payoff for issuer disclosure really emerges. Easterbrook and Fischel point out that initial investors can easily bargain for certification, information, covenants, etc.\footnote{200}{See Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 VA. L. REV 669, 682–83 (1984).} (At a certain point the numbers make individual bargaining inefficient, but leave that to one side.) In the secondary market such bargains prove much more difficult, particularly after the initial resale. Even the first buyer of a resale transaction is no longer in privity with the issuer.\footnote{201}{Langevoort & Thompson, supra note 179, at 363.} Buyers two or three steps downstream, if they are to exist, must rely on disclosure; and for these buyers mandatory disclosure is better than voluntary disclosure for the traditional reasons described above: information is a public good, is costly to coordinate, and will increase social welfare—at the point where a secondary market exists.

Note that whether the private market buyers can "fend for themselves" is conspicuously absent from this analysis, just as it plays no role in traditional law and economics justifications of mandatory disclosure. The traditional justifications for mandatory disclosure—efficiency in scale and the utility of the public good of information—are indifferent to the buyer’s sophistication. Yet current law nevertheless discriminates on the basis of wealth, as a proxy for sophistication, or the ability to fend for oneself. Securities law thus in theory, as in practice, marginalizes the average investor without acknowledging that it does so, let alone justifying it.

\subsection*{C. The Problem with Sidelining the Little Guy}

The SEC's legislative charges are to protect investors and to promote efficiency, competition, and capital formation. Limiting the general public from investing in risky private offerings may well serve the ends of both

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\footnotesize{199. Although section 12(g) of the Exchange Act provides that companies with over 500 shareholders of record are subject to many of its disclosure requirements (and conventional wisdom has it that this requirement explains why Google and Facebook went public), the SEC counts shareholders "of record" narrowly. Langevoort, supra note 185, at 1068–69. Section 501 of the JOBS Act increased the record-holder threshold from 500 persons to 2,000 persons or 500 persons who are unaccredited investors. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012).
201. Langevoort & Thompson, supra note 179, at 363.}
capital formation and investor protection. Giving only wealthy and sophisticated investors special chances for big gains, after all, may help move capital into the hands of cash-hungry young companies, while protecting those investors who can least afford the risks that attend opaque and illiquid investments.

Make no mistake, these markets are risky. Illiquid and opaque, they represent the opposite of a guaranteed payout—indeed, they offer the chance of losing everything just as much as a chance at high returns. For me, at least, the risks of allowing retail investors to participate directly in this market—particularly given the substantial commitments involved—would be too great. Even if it were possible for the average investor to scrape together the minimum $30,000 needed for an investment on SharesPost, for example, relying so heavily on the performance of one company is a recipe for investment disaster.

Yet there is a real harm in shutting average investors completely out of this market. As Professor Houman B. Shadab puts it, “Modern finance has one overriding lesson: investors can minimize risk by placing their capital into a diverse portfolio of securities from numerous different issuers and different types of assets (e.g., stocks, bonds, commodities, real estate, etc.).” While risky assets such as private company stock should not play a large role in the average investor’s portfolio, they have their place for two reasons. First, greater risk should carry with it greater returns. Second, diversification of assets reduces risk to the extent that the performance of those assets does not correlate. In other words, if various asset classes do not move in tandem, gains in one area should help to offset losses in another. Investors who are underdiversified risk missing out on gains, particularly in areas like the private markets, where high return should accompany the high risk they represent.

Moreover, government intervention in this particular market seems unjustifiable for a number of reasons. Focusing on the risks that stocks pose is somewhat inexplicable, given that individuals are free to lose their shirts in a variety of ways. People can purchase cars or homes they cannot afford, or gamble away their savings in a casino or on lottery tickets, all without government interference. While it is true that the market might price some buyers out of certain mortgages or car loans, having a market


203. Shadab, supra note 191, at 267.

204. Id.

205. Id.

judge that people cannot afford to buy an item is quite different from the government prohibiting them from purchasing it as a matter of law. 207

Secondly, underdiversification—shutting out retail investors from a particular asset class—is a real danger.

More broadly, the merits of private equity funds have been a recurrent topic of our national conversation—particularly in light of recent Republican presidential candidate Mitt Romney’s role in Bain Capital, a private equity firm. The discussion has often focused on whether private equity funds are “good” or “bad,” job creators or job destroyers. The standard economists’ answer is that investors should be indifferent. In the case of hostile acquisitions that profit the acquirer at the expense of the target, for example, fully diversified investors will gain as much from owning acquirers as they lose from owning targets. But in the case of private equity, average investors are net losers—not because they fail to achieve the lofty summits of the private equity manager’s “two and twenty” compensation; rather, because of government regulation they cannot participate in the profits that private equity funds make, while nevertheless must share in the losses.

One logical rejoinder is that private equity returns are not what they are cracked up to be. Given the inherently private nature of these investments, pinning down their profitability has proven difficult. While there are reports of impressively high profits, 208 there are also reports of below-market returns. 209 The answer to such a critique is simple: accept, for the sake of argument, that the average investor should simply buy and hold a diversified array of publicly available assets. Take as a given that following such an investment philosophy is rational and will maximize individual returns.

Most investors do not. Stocks trade today with a frequency far in excess of what one would expect if investors were buying and holding, selling only to pay for long-term goals like college tuition or retirement. 210 Professor Stout attributes this behavior to an irrational optimism-driven speculation. Professors Choi and Pritchard describe it as a preference for gambling, at least in the respectable arena of the stock market. 211 Whatever the motivation, the desire to beat the market appears to be a fundamental feature of investor behavior. Accepting that impulse as a given, the question becomes how to deal with the problem of differential access.

207. Securities, as intangible assets, may be more susceptible to fraud than cars or houses. In Part II.D, I discuss a solution that could alleviate the fraud concern while not shutting average investors out of an entire asset class.
208. See, e.g., Harris, supra note 52, at 261.
209. See supra note 20 and accompanying text.
210. See Stout, supra note 133, at 1184.
211. See Choi & Pritchard, supra note 134, at 15.
D. The Answer: Secondary Market Funds

We can let the "little guy" have the same opportunities as the accredited investor, if we want to. A few scholars support this approach; for example, recently Professor Gubler argued that retail investors should not be "crowded out" of the private market.212 Presently, virtually no mutual funds invest in the secondary market, largely because complying with current valuation requirements makes the creation of such investment pools impractical.213 Interestingly, in 1968, right before the enactment of such regulations, mutual funds accounted for 29 percent of institutional investment in illiquid equities such as restricted shares, venture capital, and private equity investments.214 Investment in a secondary market mutual fund or closed-end fund would allow the retail investor to participate in this new market while maintaining the ability to diversify by investing in a number of companies.

As a preliminary matter, I dismiss out of hand the possibility of removing the qualification of accredited investor status in order to gain direct entry into these sites. I believe, admittedly paternalistically, that the average investor should not commit a sizable amount of his or her fortune to one or two companies’ stock—whether private or public. Indeed, modern portfolio theory teaches that diversification yields the surest return.215 The wise investor will invest some money in real estate, large domestic publicly traded companies, small publicly traded companies, bonds, and international holdings. The idea is to balance some lower risk, lower return investments with other higher risk investments that could pay off big. Moreover, ideally these investments will counterbalance each other, so that when investors’ stocks are performing poorly, their bonds will be earning good returns. Within each asset class, it is safest to diversify as well. For example, rather than buying the shares of two or three Fortune 500 companies, it is more prudent to buy an index fund that owns shares of each of the 500 companies.

To review, retail investors are currently shut out of a significant asset class: the private market.216 Yet public demand for such investments exists. As Professor Steven Davidoff has documented, government regulation has driven ordinary investors to pursue substitutes for private

212. See Gubler, supra note 130; see also Smith et al., supra note 206.
213. See Smith et al., supra note 206, at 421–22.
214. Id. at 427, 471–72.
215. See supra note 19 and accompanying text.
216. There is at least one exception: GSV Capital. GSV is a publicly traded company that invests in private shares via SharesPost and SecondMarket. Its website proudly proclaims: “GSV Capital is democratizing access to VC-backed companies.” GSV CAPITAL, http://gsycap.com/about/ (last visited Apr. 19, 2013). Because it is not a mutual fund, it does not suffer from the same asset valuation problems that currently discourage secondary market mutual funds. See Tomio Geron, GSV Capital Investment Values Facebook at $70 Billion, FORBES (June 27, 2011, 1:38 PM), http://www.forbes.com/sites/tomiogeron/2011/06/27/gsv-capital-investment-values-facebook-at-70-billion/.
equity, which he terms "black market capital."²¹⁷ Such investments, including investing in private equity firms themselves when they go public or employing special purpose acquisition corporations, are imperfect substitutes for true private equity.

The logical way in is through a fund that aggregates small investments in different private companies, private equity funds, or hedge funds. One alternative is to create a secondary market mutual fund. Although in theory mutual funds could invest in the secondary market, in practice a combination of SEC valuation rules and mutual fund requirements has combined to discourage such investment. To understand the relevant rules and regulations, readers should keep in mind that a key feature of the typical mutual fund²¹⁸ is that it permits shareholders to redeem their shares for cash—in other words, mutual fund holders have the right to demand money from the company in exchange for their shares at any time.²¹⁹ Liquidity is thus a major concern for a mutual fund.

The SEC limits the amount of illiquid securities a mutual fund can hold to 15 percent.²²⁰ Moreover, it requires that mutual funds value illiquid assets "at the price that they would command upon a 'current sale'—or, in other words, an immediate liquidation of these securities."²²¹ The board of directors of the mutual fund must certify that the valuations are accurate, thus exposing it to risk if the valuations are too high.²²² While the liquidation value is important given mutual funds' unique redemption feature, imposing a liquidation measure of value fails to reflect the underlying investment's value if the fund adopts a "buy and hold" strategy: that is, if it plans not to trade the private company stock immediately, but rather to wait for an IPO or trade sale.²²³ Thus, the redemption feature and its attendant need for liquidity at the fund level are in tension with the illiquidity of the underlying assets of a fund that specializes in the secondary market. Accordingly, such funds may want to limit the windows when investors can exit, or impose redemption fees to discourage withdrawal.²²⁴ Some have suggested allowing mutual funds "more latitude" in valuation, and perhaps alternatives to the certification requirements.²²⁵ The former choice is the more appealing to me, and

²¹⁷. Davidoff, supra note 139, at 178–79.
²¹⁸. By which I mean an open fund, as opposed to a closed-end fund. See infra notes 227–29 and accompanying text.
²²¹. Gubler, supra note 130, at 806; see also Smith et al., supra note 206, at 423.
²²². Gubler, supra note 130, at 806.
²²³. See id.
²²⁴. Rule 22c-2 under the Investment Company Act permits the boards of companies that redeem shares within 7 days to adopt a redemption fee of no more than 2 percent. 17 C.F.R. § 270.22c-2(a) (2012).
²²⁵. Gubler, supra note 130, at 807; Smith et al., supra note 206, at 467–69.
perhaps could be coupled with requiring investors to affirm that they understand the illiquidity of the underlying secondary fund’s assets and the difficulty involved in valuing them.

Alternatively, closed-end secondary market funds would not face the same liquidity pressures as mutual funds. Unlike their mutual fund counterparts, the shareholders of closed-end funds lack the right to redeem their shares for cash. But they trade on the public securities exchanges in a secondary market just like ordinary public companies. The liquidation value of these funds is thus less important than it is to mutual funds, since selling shareholders will not be claiming their share of the fund’s assets from the fund itself (i.e., redeeming the shares), but rather selling them on the secondary market at whatever price the market will bear. Closed-end funds seem in many ways tailor-made for investment in the private market, if only released from the liquidation measure of valuation the SEC currently requires.

Moreover, public investment via secondary market funds may well prove more attractive for private firms themselves. Even absent federal regulations, most firms might well be loath to agree to small dollar value investments from myriad average investors; the transaction costs alone make the prospect unattractive, as compared to investments from wealthy investors willing to buy large amounts of stock. Such reluctance may well explain why, even though existing laws permit a limited number of unaccredited investors to participate in private offerings, in practice few private companies make use of them and actually sell to unaccrediteds. Mutual fund mediation permits the agglomeration of unaccredited investment dollars to the point where such investments might be more palatable to private firms.

It may be that mutual fund managers’ incentives need to be tweaked to make such a change viable. Professor Paul Mahoney has identified the agency problems inherent in tying mutual fund managers’ compensation to

228. Id.
229. Smith et al., supra note 206, at 434 (“Differences between NAV and market values may be of little relevance to investors in closed-end funds that invest in restricted shares of reporting companies. The fund’s valuation methodology is likely to involve benchmarking against the market values of freely tradable shares and is subject to the SEC’s constraints. As long as investors have access to specific information about the fund’s holdings, the board’s valuation is unlikely to contribute to market valuation.”); see also id. at 470 (“A closed-end fund is essentially a publicly owned company. However, in contrast to publicly owned companies, the fund must prepare its financial reports on the basis of liquidation value, and not on the basis of historical cost. For healthy public corporations, it is easy to see that liquidation value is not important to investors, who are attempting to determine going-concern value.” (citation omitted)).
230. See Campbell, supra note 171, at 98.
the amount of trading. If one views private equity’s performance-based incentive structure as a chief constraint on agency costs, then laws precluding such compensation in the mutual fund industry become problematic. Mahoney posits that federal regulations “unintentionally exacerbate” fund manager/shareholder conflict by segregating sophisticated and unsophisticated investors, allowing the former access to hedge funds while relegating the latter to mutual funds, where fund managers use creative techniques such as stale-price arbitrage and “soft dollar” commissions to evade federal strictures on compensation. Mahoney suggests allowing retail investors to invest side by side with institutional investors and relaxing the compensation structure in such funds to allow for more experimentation in compensation.

If, despite my arguments, questions linger about the prudence of allowing the general public into such risky assets—even in a diversified form—then we could limit the public’s exposure to this asset class to 10 percent of net worth or income, mirroring the JOBS Act’s “crowdfunding” provisions (which allow little-guy investors to put a limited amount into small private companies seeking up to $1 million in funds). While it may seem at first blush that CROWDFUND is an accredited investor exemption for the everyman, the opposite appears to be true. The traditional venture-backed start-up requires several millions of dollars in funding. Most companies that require less than $1 million are not your typical high-growth, get-in-on-the-ground-floor investment. CROWDFUND does nothing to allow average Joes into the traditional, and profitable, private market. Instead, it creates new capital-raising opportunities for small business and start-ups—a laudable goal, but not one that gives the retail investor access to traditional accredited investor territory. In other words, even with CROWDFUND, the real home runs are still reserved for the big wallets. Letting ordinary investors into the private market, in contrast, gets ordinary investors a piece of the action.

Such mutual funds could take on or reinforce aspects of the role angel investors and VCs played in the traditional venture capital world described

233. Id. at 180 (calling for a “mix of institutional and retail participation”).
234. Title III of the JOBS Act, the CROWDFUND Act, allows issuers to sell up to $1 million of securities in a twelve-month period without 1933 Act registration. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat. 306, 315 (2012). Any investor can invest in these companies—they are not reserved for accrediteds only. If an investor’s annual net worth or income is less than $100,000, she can invest no more than 5 percent of her net worth or annual income (or $2,000, whichever is greater). Id. § 302(a)(6)(B)(i). If an investor’s annual net worth or annual income is equal to or more than $100,000, then she can invest no more than 10 percent of her net worth or annual income (or $100,000, whichever is greater). Id. § 302(a)(6)(B)(ii).
235. See supra Part I.A.1–2.
in Part I.A—the very role that the secondary markets currently threaten. Because of the illiquid nature of their underlying assets, these mutual funds would be motivated to ensure that the private equity funds in which they invest are actually nurturing or at the very least monitoring their own portfolio companies. To the extent that mutual funds invest directly in private firms, they can assume the nurturing and monitoring role themselves. In sum, the move to let the little guy into the private market via mutual funds could benefit both investors and companies by introducing a new institutional player with the capacity and incentive to effect real change.

Allowing secondary market mutual funds would be a significant step, and limiting the size of retail investors’ investment to 10 percent of net worth, à la CROWDFUND, might make it more politically palatable. Such limitations ultimately invite a larger question: Why must investors be protected from certain types of securities when they are free to lose their life savings in the public markets or at casinos? Ultimately, any discussion of limiting investor options invites a broader discussion of the appropriateness of selective government intervention in certain investors’ lives. I save such questions for a later day.

E. Who Is Keeping Securities Law’s Dirty Little Secret?

Given the potential benefits of allowing the retail investor into these markets, the question might fairly be posed: Why does this stark divide between investing haves and have-nots exist? Other countries have allowed average citizens to invest in hedge funds. In other formerly off-limit investment areas, such as options, futures, and real estate investment trusts, investor demand has precipitated increased access. Yet in the United States, unaccredited investors can only participate in the private market indirectly via pension funds (for those lucky enough to still have pensions at all).

Public choice theory provides one answer to this puzzle, although perhaps a surprising one. The standard public choice story involves a rule that the majority of voters disfavor, but a small interest group champions. Widely dispersed, general voters arerationally ignorant regarding the issue and equallyrationally disinclined to educate themselves on it or to mount an opposition. And so the interest group carries the day, succeeding in

236. See Shadab, supra note 191, at 253 (citing Australia, Switzerland, Hong Kong, Singapore, Ireland, and the United Kingdom).

237. See Smith et al., supra note 206, at 460 & n.245.

238. See David A. Skeel, Jr., Public Choice and the Future of Public-Choice-Influenced Legal Scholarship, 50 VAND. L. REV. 647, 651 (1997) (reviewing MAXWELL L. STEARNS, PUBLIC CHOICE AND PUBLIC LAW: READINGS AND COMMENTARY (1997) (describing interest group analysis public choice’s “central insight” that concentrated interest groups often benefit at the expense of a larger, more diffuse group, even when the latter group has more to lose).
lobbying to pass legislation or to persuade an agency to adopt a rule that runs counter to the majority’s preference.\textsuperscript{239}

The collective action side of the accredited investor exemption public choice story is easy to tell. The typical retail investor spares little thought for his investments in general and their scope in particular. Most investors probably never even consider the possibility of investing in hedge funds, private equity, or the shares of private companies. Indeed, the array of investment opportunities already open to them is overwhelming. When they set up an IRA or 401(k) (where the lion’s share of investing decisions are made for the average worker),\textsuperscript{240} no one tells them they cannot invest in private equity—they are just never given the choice.

The special interest side of the public choice story is more difficult. As Part II.A showed, private firms had every incentive to lobby Congress and the SEC for a bright-line rule as to who was able to “fend for themselves.”\textsuperscript{241} Such a rule did not really disempower small investors, who had never previously been able to invest in these types of funds to begin with. Instead, it merely crystallized the wealth levels needed to gain access to privileged investments. The problem for retail investors, in other words, is that from their perspective the accredited investor exemption is a tale of inaction: while others were at the table clamoring for a share, they were not. However, there has been a puzzling market failure on the part of mutual funds since 1969-70 to lobby for changes to regulations that might permit them to offer private company mutual funds to the public.

On the other hand, it is easy to explain the inaction of the SEC, the other major player. As Gubler has pointed out, while conventional public wisdom would suggest that the SEC would seek to enlarge its regulatory turf at every turn—in order to gain currency its regulators can use to curry favor with, and ultimately lucrative jobs from, private industry\textsuperscript{242}—there are good reasons for the SEC to hesitate to open up the private markets. Private firms have not lobbied to expand the accredited investor definition to the general public, and if they do not desire such reform—as may well be the case, given the desire of private equity firms, in particular, to avoid the limelight\textsuperscript{243}—then the potential for private gain on the part of regulators is greatly diminished. Moreover, if average investors lost money in these markets, the SEC would face withering criticism that it had failed in its mandate of investor protection.

\textsuperscript{239} Id. at 652.

\textsuperscript{240} Accord Dana M. Muir, The U.S. Culture of Employee Ownership and 401(K) Plans, 14 Elder L. J. 1, 9 (2006) (“By the end of 2003, an estimated 42 million employees participated in 401(k) plans and plan assets totaled $1.9 trillion.”).

\textsuperscript{241} See Karmel, supra note 174, at 686–87.

\textsuperscript{242} See Gubler, supra note 130, at 769.

Indeed, the “precautionary principle,” which Commissioner Troy Paredes points out may drive the SEC to regulate the hedge fund industry,²⁴⁴ counsels against increasing investor access to the private markets. When rich widows and orphans lose their savings, people tut-tut. When it is poor widows and orphans that suffer, regulators’ heads may roll. Take the fallout the SEC faced from failing to catch the fraud of Bernie Madoff and then multiply it a hundredfold. Indeed, the scandals that so often drive regulation all point the other way—toward limiting investment options rather than expanding them. As long as differential investment access remains a secret, there will be little pressure for change.

CONCLUSION

This Article has described the new secondary market for private shares, which threatens to upset a tacit balance the securities markets have long struck. The tradeoffs used to be pretty clear. If you were an ordinary investor, you could buy shares of publicly traded corporations or funds that invested in such corporations. You knew that these companies disclosed massive quantities of information to the SEC and traded on national stock exchanges that also kept an eye on the corporations’ behavior. Thus, along with your shares you bought some measure of safety and almost perfect liquidity; if you needed to get out of your investment, you could do so at minimal cost. Along with liquidity came the ability to diversify your holdings. Putting your eggs in a number of baskets, you were less vulnerable should any one basket be lost.

If you were an accredited investor, however, you could also invest in private companies—companies that use special exemptions to sell their securities without registering them with the SEC—thereby avoiding the substantial accompanying costs and disclosure requirements. You could invest in venture capital or private equity funds as well, pooling your resources with other accredited investors to invest in early stage companies.

Private equity returns have at times spectacularly outstripped those of publicly available investments.²⁴⁵ Other times they have underperformed the market—by their nature, they are risky and volatile.²⁴⁶ In the aggregate, they offered valuable exposure to a unique asset class, contributing to the diversification of the portfolios of those privileged to be able to invest in them. But generally these funds require a ten-year or longer commitment.

Thus, the tradeoff: in the old world, accredited investors had special access to private investments that promised higher returns, but they accepted diminished liquidity as a price of their investment. Generally, if you wanted to invest in private corporations, you had to be not only rich but

²⁴⁴. See Paredes, supra note 198, at 1006–07.
²⁴⁶. See id.
also patient. And in part because of this de facto illiquidity, these investors were seen as bringing “smart money” to the table. Put another way, these investors were sophisticated repeat players, but they were also motivated to monitor the company’s performance. Heeding Mark Twain’s advice, traditional accredited investors put lots of eggs in one basket—and then watched that basket.247

The secondary markets mean that private investors no longer need watch their baskets quite so closely. Now the rich but dumb money can invest in private firms, potentially at the expense of the companies themselves, who may lose both the soft nurturing and the chance to raise cold hard cash that the old system afforded them. Now the rich have liquidity and special access to privileged investments. If this new bargain, coupled with the increased visibility these markets and recent changes in the law provide, proves less tenable than the old one, then perhaps it is time to revisit some basic assumptions undergirding our securities laws.

247. See Mark Twain, The Tragedy of Pudd’nhead Wilson 197 (1894) (“Put all your eggs in the one basket and—watch that basket.”).