Written Testimony of
Elisabeth de Fontenay
Professor of Law, Duke University

Before the United States House of Representatives
Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets

“Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment”

September 11, 2019
10:00 a.m.
2128 Rayburn House Office Building
EXECUTIVE SUMMARY

- The SEC seeks public comment on various proposals that would expand or create new exemptions from the securities registration requirements.

- Such proposals would allow small-dollar retail investors to invest directly in private securities.

- Such proposals purport to address:
  - (1) inequality in the investment opportunities available to retail investors, who, unlike institutional and high-net-worth investors, generally cannot purchase private securities; and
  - (2) a lack of capital for small issuers.

- It is my view that these proposals misunderstand the purported problems that they seek to solve and will in fact exacerbate them:
  - The public markets were specifically designed to create an even playing field for retail investors relative to corporate insiders and sophisticated investors.
  - If permitted to invest in the private markets, we should expect retail investors to earn lower risk-adjusted returns than they do in the public markets.
  - There is no evidence that good issuers currently lack capital in the private markets
    - A long period of historically low interest rates has led to a glut of capital in both the public and the private markets.
    - Retail investors are not needed to provide capital to emerging companies, and promising companies do not appear to want them.

- Policymakers are right to be concerned about the growth in private capital:
  - Private capital-raising now vastly outpaces public capital-raising.
  - U.S. public companies are significantly older and fewer as a result.

- The decline of public capital-raising is due in large part to the dramatic deregulation of private capital under the securities laws over the last several decades.
  - Further deregulating the securities registration regime would therefore only exacerbate the problem.

- We should be especially cautious about further deregulating the registration regime today, because (a) we lack so much information about the private markets and (b) there are troubling signs of overheating in the private markets.

- Stemming the decline of public companies may require mandating more firms to go public, for example by tightening the size threshold for registration under the ‘34 Act.
Ms. Chairwoman Maloney, Ranking Member Huizenga, Members of the Subcommittee:

Thank you for inviting me to testify at this hearing. I am a Professor of Law at Duke University, where my research focuses on corporate finance, corporate law, and private investment funds. Before becoming an academic, I practiced law for six years at Ropes & Gray LLP, where I helped advise major private equity firms and institutional investors on a variety of matters.

The U.S. public securities markets have been the envy of the world for decades, allocating capital efficiently to businesses that need it and providing good returns to retail and institutional investors alike. Yet we often forget that the public markets are a creation of the federal securities laws. These laws require that all securities be registered with the SEC prior to being offered and sold to investors—a process that requires substantial public disclosure regarding the issuer and the offering. Thereafter, public companies are also required to provide investors and the public with basic information on a periodic basis, as well as when significant events occur.

The general rule requiring registration of offerings and ongoing reporting is subject to a host of exemptions, however. Those exemptions have expanded dramatically over the last few decades. Thus, the securities laws and regulations create a complex framework determining when registration and disclosure are required, dividing corporate securities and issuers into a “public” side and a “private” side. In recent years, the amount of capital raised in private offerings has dwarfed the amount of capital raised in public offerings, so it is fair to say that the exemptions have swallowed the rule.

This is an excellent time to examine whether this regulatory regime makes sense for our markets.

Earlier this year, the SEC issued a Concept Release exploring these exemptions. The Concept Release focuses on two issues with this framework of registration requirements and exemptions. First, the SEC inquires whether retail investors are missing out on potential growth opportunities to

---

1 C.f. Donald C. Langevoort, The SEC, Retail Investors, and the Institutionalization of the Securities Markets, 95 VA. L. REV. 1025, 1072 (2009) ("The United States is the only country in the world with a truly broad and active retail investor base for direct equity investment.").
3 See id. at 21-23.
which institutional and high-net-worth investors have access, because the securities laws mostly prevent retail investors from investing directly in private securities. Second, the Concept Release inquires whether the current registration rules may prevent some issuers from raising the capital that they need, because they are too small to access the public markets and they cannot attract institutional or high-net-worth investors.

To remedy these concerns, the SEC seeks public comment on various items, including proposals (1) to expand or create new registration exemptions, (2) to loosen the restrictions on the secondary trading of private securities, and (3) to relax the standards for what constitutes an “accredited investor.”

To be very clear, such proposals would have the primary aim and effect of allowing small-dollar retail investors to invest directly in private securities. Indeed, issuers are already permitted to raise unlimited amounts of capital privately from institutional and high-net-worth investors, with no material disclosure obligations whatsoever.4

Based on the large body of existing research and reporting on the capital markets, it is my view that these proposals not only misunderstand the purported problems that they seek to solve; they are likely to exacerbate these problems and to create new ones.

The notion that retail investors are “missing out” on the opportunity to invest in private securities is based on faith, rather than data. The available research suggests that they would do materially worse on average in the private markets than in the public markets. Nor would direct retail investment in the private markets be good for capital allocation: in our current glut of capital, firms that still cannot attract capital from institutional or high-net-worth investors are likely the smallest firms with the very worst prospects, which are wholly unsuitable investments for retail investors.

There is considerable room for reasonable disagreement over whether public companies and the public markets are subject to too much regulation. By contrast, it is my view that one cannot reasonably argue that increasing retail-investor presence in the private markets would be good for investors or

---

4 For example, under Rule 506(b) of Regulation D, issuers may raise an unlimited amount of capital with no required disclosures to investors, so long as the securities are offered only to “accredited investors.” See 17 C.F.R. § 230.506(b). Under this exemption, the issuer’s only disclosure obligation is the post-closing filing with the SEC of Form D, a simple two-page notice providing summary information about the issuance.
good for capital allocation, based on the evidence at our disposal.

To speak candidly, what we know of the investment behavior of retail investors—based on decades of research—is overwhelmingly alarming. The fact that we have finally achieved some success in steering retail investors’ 401(k) investments to low-cost index funds of public securities should be considered one of the crowning achievements of the last decade in investor protection. It is worth noting, however, that it took decades to make progress on this front, during which time retirement investors collectively lost or passed up billions of dollars per year as a result of poor investment choices, excessive fees, and transaction costs, typically without ever realizing it. And this shift required considerable paternalistic interventions, such as actively limiting investors’ 401(k) options and automatically enrolling them in low-cost index funds.

In 2019, we can finally say that retail investors’ retirement money is beginning to move to the appropriate place, even though we have known for over half a century that retail investors belong in widely diversified, low-cost, indexed portfolios. That we would choose this moment to encourage retail investors to pursue undiversified, high-risk, high-cost investments with poor return prospects seems puzzling, to say the least. This is particularly true when serious warning signs point toward overheating in the private capital markets, where complaints of too much capital chasing too few good ideas have become a constant refrain.

If Congress and the SEC are concerned about investment opportunities for retail investors, the solution lies not in throwing retail investors to the wolves in the private markets, but rather in ensuring a healthy pipeline of companies going and remaining public. This may require reversing course on Congress’s approach of allowing companies to remain private indefinitely, despite multi-billion-dollar valuations and widely dispersed share ownership. The share of public companies in the U.S. has declined markedly over the last few decades, in no small part due to the dramatic deregulation of private capital over the same period.

Without question, the private markets play a significant and important

---

5 See William A. Birdthistle, Empire of the Fund: The Way We Save Now 71-88 (Oxford University Press, June 2016). Professor Birdthistle estimates the minimum annual fee revenue to the mutual fund industry to be approximately $100 billion. See id. at 62. Of that amount, a conservative estimate would be that shareholders are paying tens of billions annually in fees for actively managed funds, rather than cheaper and better performing index funds.
role in financing U.S. businesses. Yet rather than blindly continuing to expand exemptions from securities registration, we should pause to ask whether doing so undermines the public markets that have served retail and institutional investors so well.

I. RETAIL INVESTORS IN THE PRIVATE MARKETS? THE INVESTOR PERSPECTIVE

The push to expand opportunities for retail investors to invest directly in the private markets is based on the perception that retail investors are at a disadvantage relative to institutional and high-net-worth investors with respect to investment opportunities. Yet doing so would only exacerbate any such disparities.

A. If retail investors are given more direct access to the private markets, we should expect them to earn lower risk-adjusted returns overall than they do in the public markets.

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

The current angst over retail investors’ investment opportunities centers on a perceived inequality relative to institutional and high-net-worth investors. The latter are permitted to invest in private securities, while retail investors largely are not. The often-repeated claim is that investors obtain better returns in the private markets than in the public markets.

The evidence does not support this assertion, however, even for institutional investors.6 Contrary to the received wisdom, the most recent and comprehensive studies show that the returns from investing in the public and private markets have been converging over time, and any excess returns in the private markets have mostly dissipated today.7 Such convergence is

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

7 For studies documenting the decline in returns to private equity investors over time, see, e.g., Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, How Do Private Equity Investments Perform Compared to Public Equity?, 14 J. INV. MGMT. 14, 15 (2016); Ludovic Phalippou, Performance of Buyout Funds Revisited?, 18 REV. FIN. 189, 189 (2014); Ludovic
precisely the result one would expect, given how much capital has shifted to the private markets and how competitive they have become.

Evidence showing outperformance of the private markets relative to the public markets are based on data from earlier decades, when private equity and venture capital were relatively new asset classes. Facing little or no competition for investments, many such funds could boast of market-beating returns. That is no longer the case today, when the number of private investment funds and the capital that they manage have skyrocketed, leading to fierce competition and substantially lower returns. Ironically, one of the most frequently cited studies for the proposition that the private markets outperform the public markets makes this explicit: the authors find that returns to investors in private equity funds with post-2005 vintage years have been roughly equal to returns in the public markets.8

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

Thus, the best evidence today suggests that, on average, even institutional investors may be doing no better in the private markets than they would investing in a broad index of public securities.9

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

Because private firms today face a seemingly bottomless supply of capital from institutional and high-net-worth investors, the firms that seek out direct investment from small-dollar retail investors are likely to be the firms with the worst prospects.10 This has two significant implications.

8 See Harris et al., supra note 7, at 15.
9 Even if one could show that institutional investors earned superior returns in the private markets, the excess return would likely be compensation for the additional liquidity risk associated with private securities. Investments in private firms and in the private markets are considerably harder to sell quickly and with low transaction costs than in the public markets. Institutional investors are well suited to bear liquidity risk; retail investors are not.
10 See Part II.A.5.
First, studies showing returns to very large institutional investors in the private markets are simply not predictive of what the returns to small-dollar retail investors would be: rather, such studies represent an unachievable upper bound on those returns.

Second, these investments would be highly unlikely to meet FINRA’s “suitability” standard and the SEC’s recently adopted Regulation Best Interest in order for brokers to recommend them to retail investors. Given that, it seems particularly problematic that the SEC seeks to allow small-dollar retail investors to invest directly in such securities.

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

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

a. Information Asymmetry.

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

The amount of information available in the private markets is very limited, and is distributed unevenly across investors, even in the very same firm. Private securities are also largely illiquid—that is, there is dramatically less trading than in the public markets. The combination of these two factors means that there is generally no single “market price” at any given time for private securities, and there is no reason to believe that the pricing of private securities is efficient. For example, even the very largest private firms—the so-called “unicorns”—face startling valuation issues.

---

11 See James D. Cox, Who Can’t Raise Capital? The Scylla and Charybdis of Capital Formation, 102 Ky. L.J. 849, 862 (2013) (“[I]t is difficult to believe that investing in a small business, and particularly one with little operating history and little liquidity for its shares, is appropriate for the investor who is neither accredited nor sophisticated.”)


Given that, access to information is crucial for valuing private securities. Unfortunately, even assuming that retail investors were sophisticated enough to value private securities, they would be unlikely to have access to the necessary information. Because they are not subject to the mandatory disclosure regime that applies in the public markets, private issuers are not required to disclose even the most material information affecting them, such as the loss of the firm’s largest customer, the departure of the CEO, or the initiation of a major lawsuit or government investigation.

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

To illustrate this concern, consider that before it went public earlier this year, the car sharing service Uber was the largest of the private company unicorns. In January 2016, while raising additional equity capital at a $62.5 billion valuation, its shares were marketed to high-net-worth individuals who were not given any financial statements whatsoever for the company.

b. Liquidity Risk.

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


costs could easily eliminate any gain on the sale.

c. **Lack of Recourse.**

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

To take only one example, while the prohibition on insider trading applies both to public and private securities, it is extraordinarily difficult to detect and to enforce in the private markets, due to the lack of mandatory disclosure and the absence of a continuous market price for the issuer’s securities.

Thus, even if retail investors were able to invest alongside institutional investors in the private markets, they would be at the mercy of not only issuers and insiders, but also institutional investors with considerably more bargaining power, more sophistication, and more information.

**B. The public markets were specifically designed to create a comparatively even playing field for retail investors relative to corporate insiders and sophisticated investors. Meanwhile, the private markets offer few, if any, of the protections that retail investors receive in the public markets.**

The U.S. public securities markets are a creation of the federal securities laws enacted following the Great Depression. These laws require (1) that issuers register publicly with the SEC any offering or sale of securities, subject to various exemptions, and (2) that certain issuers provide ongoing reporting to the public. This scheme creates a sharp divide in U.S. corporate finance—with registered offerings and reporting companies representing the “public” side, and exempt offerings and non-reporting issuers representing the “private” side.17

Since their enactment over eighty years ago, such laws have largely confined retail investors to the public side of the divide, with the express goal of creating a market in which such investors would not be at the mercy of

---

corporate insiders or more sophisticated investors.

1. Efficient Markets.

The most important mechanism in the public markets for leveling the playing field among investors is the mandatory disclosure regime. It is often said that mandatory disclosure provides retail investors with the information that they need to make their own investment decisions. More accurately, however, mandatory disclosure allows retail investors to avoid making investment decisions at all. By ensuring that all material information regarding an issuer is publicly disclosed, the securities laws facilitate market mechanisms that result in securities prices that reflect all such information. Thus, retail investors need never read or even be aware of public issuers’ securities filings. When buying public securities, they can reasonably assume that such securities are accurately priced by the market.

The public markets are therefore designed precisely so as to put retail investors on a level playing field with institutional investors, insiders, and other sophisticated and informed traders. Without any effort on their part, retail investors get the benefit of the same share price as everyone else, and they have reason to believe that the market price is the correct price.

By contrast, private securities cannot be said to be efficiently priced in the same way. Because they do not trade continuously, they lack a “market price.” Further, when private securities are bought and sold, they may sell at very different prices to different parties. As discussed above, there is no assurance that investors or potential investors will be aware of material information about the issuer, such as the CEO’s departure, the loss of the firm’s top customer, the commencement of a government enforcement action, and so forth. Under such conditions, insiders and large investors with special access to information about the issuer have a substantial advantage.

2. Other Investor Protections.

The public markets offer various other protections that serve to level the playing field for retail investors. While too numerous to discuss in detail here, they include, among others:

(1) the regulation of gatekeepers in the public markets (such as auditors

---

and underwriters); (2) the regulation of the intermediaries through which retail investors
tend to invest and trade in the public markets (such as investment
advisers and broker-dealers); (3) corporate governance requirements for public companies (such as the
requirement of an independent audit committee); (4) mandatory disclosure designed to limit managerial agency costs (such as reporting on executive compensation, trading by insiders, and self-dealing);\footnote{Paul G. Mahoney, \textit{Mandatory Disclosure as a Solution to Agency Problems}, 62 U. \textit{Chi. L. Rev.} 1047, 1048 (1995) ("[T]he principal purpose of mandatory disclosure is to address certain agency problems that arise between corporate promoters and investors, and between corporate managers and shareholders.")} (5) rules against selective information disclosure by issuers (such as Regulation FD); and (6) the regulation of shareholder voting in public companies (the proxy rules).

To conclude this Part I, the available evidence suggests that retail investors would fare materially worse in the private markets than in the public markets. Concerns about inequality for retail investors are therefore not a sound basis for allowing retail investors into the private markets. The public markets exist precisely to mitigate any such inequalities.

\section*{II. RETAIL INVESTORS IN THE PRIVATE MARKETS? THE ISSUER PERSPECTIVE}

\subsection*{A. There is no evidence that issuers with reasonable prospects for growth and profitability currently lack capital in the private markets.}

1. \textit{A long period of historically low interest rates has led to a glut of capital in both the public and the private markets.}

We are in a period of abundant capital, both in the public and the private markets. As finance theory predicts, historically low interest rates maintained over a long period of time have led to a boom in capital. U.S. businesses face an embarrassment of riches when looking to finance their operations. In the public markets, companies overall are not even seeking capital: lacking new projects in which to invest, they are returning more capital to shareholders.
through buybacks and dividends than they are raising in new financing overall. In the private markets, tech unicorns with soaring valuations may be facing a reckoning: some that have recently completed or begun the IPO process have experienced startling corrections to their valuations and revealed festering governance problems.\textsuperscript{20}

Contrary to the premise of the SEC’s Concept Release, if there is a problem with capital allocation today, it is that there is too much money chasing too few opportunities. Indeed, signs of an excess of capital are popping up throughout the capital markets, with troubling parallels to the period preceding the financial crisis of 2008-2009.\textsuperscript{21} Overall, there is no evidence that capital is scarce today for good U.S. firms—whether public or private—and much evidence to the contrary.

2. Over the last few decades, there has been exponential growth in the number of investment funds targeting the U.S. private markets.

To gain a sense of the state of capital-raising in the private markets, the first place to look is at the largest investors in private securities, namely private investment funds such as venture capital, private equity, and private credit funds.

Only a few decades ago, when researchers began studying them in earnest, private investment funds were few, faced little competition for investments, and could boast of returns that exceeded those from investing in stock market indices by a sizable margin. Today, however, the story has changed. As one would expect, the early successes of private equity and venture capital have attracted serious competition, with the number of such funds and the capital that they manage surging to dizzying heights.\textsuperscript{22} As a result, the environment for private investment funds is extraordinarily competitive today, prompting concerns of lower returns.


\textsuperscript{21} These include, among many others, (1) the decline of underwriting standards in corporate debt (particularly leveraged loans); (2) rising leverage ratios in private equity-financed acquisitions; (3) a spike in IPOs or private financing rounds for very large firms that have yet to achieve profitability; and (4) a shift in bargaining power from investors to founders (reflected in the rise of dual-class stock structures, for example).

\textsuperscript{22} See Javier Espinoza, \textit{Private Equity Funds Active in Market Reach All-Time High}, FIN. TIMES (Apr. 25, 2018), https://www.ft.com/content/c74e10c6-47d2-11e8-8ae9-4b5ddcca99b3 (describing record-breaking fundraising by private equity funds).
3. Such funds compete fiercely for investment opportunities today, and are in fact struggling to deploy their capital.

As a result of this crowding in the venture capital and private equity space, such funds currently hold massive reserves of “dry powder”—that is, capital commitments from investors that have not yet been invested. Institutional investors such as pension funds, sovereign wealth funds, university endowments, and others, have dramatically increased their investment allocations to the private markets, triggering a surge in capital. In the midst of record-breaking fundraising, many private fund sponsors are having to turn away investors’ money.23

As a result, these funds are struggling to deploy the dry powder.24 The very same forces that prompted competition among investment funds entail severe competition for investments in the private markets. Large companies also flush with capital have become highly active in the private-investment space as well: sales of private firms to these so-called “strategic acquirers” have replaced the IPO as the primary exit for venture capital investments. All of this translates into an extraordinary amount of capital available to U.S. businesses that seek it, at historically low cost. Simply stated, retail investors are not needed to provide capital to emerging companies, and promising firms do not appear to want them.

4. It is therefore implausible that there might currently be a large contingent of good U.S. firms lacking capital.

Intense competition among private investment funds and strategic acquirers makes it implausible that these investors could simply be ignoring a wealth of good investment opportunities in the private markets. The notion that these opportunities would be available to retail investors strains credulity even further. Before altering the securities registration regime, therefore, Congress and the SEC should demand evidence that promising firms are nonetheless unable to raise capital in our historically low-rate environment. For the reasons discussed above, such evidence is unlikely to be forthcoming.

---

24 See id. at 3.
5. **Issuers that are willing to accept direct investments from small-dollar retail investors are thus likely to be the product of adverse selection, if not outright fraud.**

It is worth trying to be concrete about the types of firms that would seek out direct investments from small-dollar retail investors. U.S. issuers are already permitted to raise unlimited amounts of capital from institutional and high-net-worth investors, with no material mandated disclosure or other obligations whatsoever. As discussed, these investors are desperately competing today to find issuers that will take their capital. In such an environment, issuers seeking direct investment from small-dollar retail investors would have to be those passed over by the legions of angel investors, venture capital funds, private equity funds, private credit funds, BDCs, strategic acquirers, and other institutional investors in the private markets.

Thus, the firms that will accept direct investments from small-dollar retail investors will be not only the smallest, but the worst of the lot—the product of severe adverse selection. It would be a grave mistake to steer retail investors towards these firms, when decades of research in financial economics suggest that they would be poor investments for retail investors, and that such firms are ill-equipped to manage passive investments from dispersed equity holders. Not every business idea is worthy of attracting capital, though founders always claim otherwise.

In conclusion, unlike in the public markets, where retail investors are put on a relatively level playing field, we should expect retail investors to fall to the bottom of the heap in the private markets, behind the enormous amount of “smart money.” There is no basis for believing that small-dollar retail investors would have access to good investments on good terms in the private markets.

In fact, we already have some evidence of this adverse selection, given the poor performance, noncompliance, and even outright fraud with the new Regulation A and crowdfunding exemptions.

---

25 See supra note 4.
26 Note that existing registration exemptions—such as Rule 504, Rule 506, and Section 4(2)—already allow issuers to accept “friends and family” investments by retail investors. While friends and family investments are still highly risky, at least the investors have more ability to gather and bargain for information, and close preexisting relationships provides some safeguard against opportunistic behavior by the issuer.
Thus, retail investors’ dreams of investing early in the next Amazon.com are no more than that. Yet it is worth entertaining the notion as a thought experiment. Even if retail investors managed to access to the rare startup that ultimately proved to be a success, they would still have no guarantee of emerging with a large payoff. Emerging companies raise needed funds in stages, with progressively larger and more sophisticated investors at each round, until the firm finally has a liquidity event via acquisition or IPO. Experience confirms that earlier-round investors face substantial threats of dilution with each successive round of financing. Experienced early investors such as venture capital funds protect themselves against this threat through various private ordering devices. There is no reason to expect that retail investors would be sufficiently coordinated or experienced to protect their gains against future appropriation through succeeding dilutive investments.  

B. Thus, if retail investors actually take up the invitation to invest in the private securities markets, we should expect that this would (1) exacerbate any existing inequality between retail investors and institutional or high-net-worth investors and (2) potentially allocate capital to the wrong firms—precisely the opposite of the SEC’s stated goals for these proposals.

Simplifying the regime for exemptions from securities registration is a laudable goal. Doing so as a pretext for expanding or adding exemptions would be a mistake, however, for all the reasons discussed above. In addition, doing so would further strain limited regulatory resources.

Based on the evidence at hand, the easiest and most defensible means of simplifying the registration exemption regime would be to eliminate the current exemptions for retail investors that have had immaterial uptake thus far. These exemptions appear to have cost more in regulatory time and attention than they have raised for issuers, and what little evidence we have on investor performance is troubling. Indeed, the very small uptake of certain exemptions suggests that they are superfluous and that there is no major pent up demand for retail-investor capital by private firms.

—

1518526753 (describing the poor performance of “Reg. A+” offerings); PRACTICAL LAW, WHAT’S MARKET: FEDERAL CROWDFUNDING OFFERINGS (updated as of Sept. 16, 2016) (describing “irrational outcomes” in the valuation of crowdfunded issuers).

28 See Cox, supra note 11, at 854.
III. The Surging Private Markets: How Should We Respond?

Private capital now plays a crucial role in the financing of U.S. businesses. The staggering growth of the private markets over the last few decades has yielded major successes, such as the availability of venture financing for innovative businesses, as well as painful failures, such as the bubble in mortgage-backed securities prior to the financial crisis. Do the surging private markets require changes to the federal securities law regime?

A. Proposals to increase retail-investor participation in private securities through pooled investment vehicles are based on common misconceptions about the private markets.

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

First, it is worth noting that retail investors can already access the private markets indirectly through channels such as (1) mutual funds that invest in late-stage private firms, (2) BDCs, and (3) publicly-traded private equity firms.29

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

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

---

risk that is unjustified for a retail investor with very limited funds to invest. A fund-of-funds that invested in multiple private equity funds might ameliorate the diversification problem slightly, but the fees charged by the manager of the fund would chip away at returns significantly. And these returns would vary substantially depending on the quality of both the manager and the underlying funds, something that retail investors are not suited to evaluate. 30

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

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

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

The idea that accessing the private markets will allow retail investors to invest in “the next Google” is inaccurate for several reasons. In order to be assured of having access to the high-growth issuers that generate major returns, retail investors would not only have to invest in a diversified portfolio of private securities, they would have to hold the “market” portfolio—that is, a share of all private securities. Indeed, in the public markets, just 4% of listed U.S. companies accounted for all of the gains of the U.S. stock market from 1926 to 2016. 31 Investors who did not hold shares in this vanishingly small set of issuers would have missed out entirely on the gains in the public markets. This is why market index funds are so beneficial to investors: they provide access to the tiny set of out-performers, without requiring investors

---

30 As a comparison point, decades of research confirm that retail investors’ track record of picking mutual fund managers is poor. See Birdthistle, supra note 5.
to guess which ones the winners will be.

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

Finally, a common justification for allowing retail investors to access the private markets is the claim that they provide returns that are not perfectly correlated with the public markets, creating additional diversification for investors in the public markets. Here again, the received wisdom is likely no longer correct. Due to the flood of capital in the private markets, the returns now look similar across the public-private divide, and the two should therefore be correlated. Private firms are subject to the vagaries of the business cycle, just as public firms are. For similar reasons, claims that investments in the private markets are less volatile than the public markets are also likely inaccurate.

B. Policymakers are right to be concerned about the aging of U.S. public companies.

We are in the midst of a long-term decline in the share of public companies and public capital-raising. While the need to raise large amounts of capital historically drove firms to go public, that is no longer the case today. Because firms can now raise capital so easily on the private markets—and without providing any public disclosure—many either avoid going public entirely or do so primarily as a means for insider and early investors to cash

---

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

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

34 See Ang et al., supra note 33, at 1782 (concluding that volatility for private equity is at least as high as for standard equity indices); Daniel Rasmussen, Private Equity: Overvalued and Overrated?, AM. AFF., Spring 2018, at 4.
out. From its peak in 1996, the share of U.S. listed companies relative to all U.S. companies has fallen by more than half.\textsuperscript{35} As a result of this major shift from the public to the private markets, issuers in the public markets are older and larger than in past decades.\textsuperscript{36} By the time firms finally go public today, they may already be past their high-growth stage in the corporate lifecycle. Investors in the public markets may therefore have less access to these high-growth opportunities than they did in prior decades.

This concern is worth taking seriously. There is considerable uncertainty over what these changes to the public markets entail for both institutional and retail investors in the public markets over the long term. We simply do not yet know whether investor performance in the public markets will suffer as a result of the aging of U.S. public companies.

\textbf{C. The deregulation of private capital over the last few decades triggered the decline of public capital-raising.}

It is especially ironic that we would consider further expanding securities registration exemptions to remedy the perceived decline in high-growth firms in the public markets, when that approach triggered the shift to the private markets in the first place. Indeed, while the causes of the public company’s decline are numerous and complex,\textsuperscript{37} prime among them is that Congress and the SEC have dramatically and repeatedly liberalized private capital over the last few decades.\textsuperscript{38} Firms are now able to raise as much capital as they could wish without ever going public. We should therefore not be surprised at seeing relatively fewer IPOs and fewer public companies.


\textsuperscript{36} See Credit Suisse Group AG, \textit{The Incredible Shrinking Universe of Stocks} (March 22, 2017).


\textsuperscript{38} See Elisabeth de Fontenay, \textit{The Deregulation of Private Capital and the Decline of the Public Company}, 68 HASTINGS L. J. 445 (2017).
D. **Stemming the decline of public companies may require mandating more firms to go public, for example by tightening the size threshold for registration under the ’34 Act.**

Private capital-raising now significantly outpaces capital-raising in the public markets. As discussed, firms’ delay in going public may eventually limit high-growth opportunities in the public markets to a degree that is detrimental to retail investors. It may also be highly detrimental to the price discovery and liquidity in the U.S. capital markets for which they are rightly renowned.

If they wish to slow or reverse the decline in public companies, Congress and the SEC must not only forego any further deregulation of private capital; they likely must take affirmative steps to require more companies to go public. Section 12(g) of the Securities Exchange Act of 1934 requires firms to become public companies (“reporting companies,” in the language of the statute) when they exceed a certain size, as measured by their assets or the number of shareholders of record. At the request of Facebook when it was still a private company, Congress substantially raised the shareholder-of-record test from 500 to 2,000 in the JOBS Act, allowing “private” firms with widely dispersed share ownership to avoid going public, if so desired.\(^{39}\) This change ran directly counter to the JOBS Act’s stated concern about the decline in IPOs. In order to stem the decline in U.S. public companies, therefore, it may be necessary to reverse course on this portion of the JOBS Act and to tighten the size thresholds in Section 12(g).

E. **We should be especially cautious about further deregulating the registration regime today, because (a) we lack so much information about the private markets and (b) there are troubling signs of overheating in the private markets.**

In light of these concerns, I support the general approach of the proposed bill requiring the SEC to submit a report to Congress before expanding or creating any exemption from securities registration. Such a report might be expected to provide information on the following items, among others:

---

(1) the aggregate volume of transactions using that exemption;
(2) the investors being offered and sold securities under that exemption;
(3) the information being given voluntarily to investors;
(4) the returns to investors for issuances under a particular exemption; and
(5) the incidence of fraud or reports of fraud.

**CONCLUSION**

The SEC’s proposals to usher retail investors into the private markets espouse two laudable goals: (1) remedying a perceived inequality of opportunity for retail investors and (2) encouraging efficient capital raising. Unfortunately, the proposals fail on both counts, and in fact would exacerbate the very problems they purport to address.

Drawing the line between public and private capital is no easy task for policymakers. After four decades of pushing firms and capital into the private markets, however, it may be time to slow down or to reverse the flow. Rather than allowing retail investors in the private markets, where decades of research suggest they will fare poorly, we would do better to shore up the public markets that were created specifically for them.

***