Is the Private Equity Industry Ready for the Small Investor?

By Isadora Lee

WITH HALF OF ALL AMERICANS currently investing in equities,[1] and over 91 million Americans investing in mutual funds,[2] one may well ask whether it is just a matter of time before the "small investor" will get a chance to engage in private equity investment. In a private equity transaction, a private fund usually raises capital from a limited number of sophisticated investors in a private placement and divides the profits that the fund generates among the fund managers and capital providers on a pre-negotiated basis. Since the 1940s, private equity investment primarily has been the domain of wealthy families and institutional investors. Despite the public's interest in greater investment returns, the private equity industry has rarely, if ever, seen the small investor as a potential source of capital to be tapped for start-ups, leveraged buyouts, and turn-around investments. The current collage of securities laws, combined with the Securities and Exchange Commission's (SEC) heightened scrutiny of the hedge fund and mutual fund industries makes it unlikely that the SEC will permit the small investor to invest directly in private equity or venture capital anytime soon. A number of considerations may help to evaluate whether enhancing the role of the small investor in the private equity sector is feasible.

I. The Current Regulatory Regime

TO THE MANAGERS OF PRIVATE EQUITY FUNDS, the "small investor" does not have the qualifications of pension funds, private and public employee benefit plans, insurance companies, university endowments, and very wealthy individuals; namely, the small investor is not "accredited," "qualified," or "sophisticated."[3] For the SEC's regulatory purposes, the "small investor" is likely to be the unsophisticated investor without sufficient capital and market experience to evaluate properly and assume the risks associated with private equity.

More than half a century of interactions among securities laws, investors, and fund managers has shown the difficulty of harmonizing the goals of all those involved in the private equity sector. From a regulatory perspective, the SEC's goal is to protect individual and institutional investors and the integrity of the markets through mandatory disclosure of important information.[4] From the private equity investor's perspective, the goal is to achieve high investment returns that are commensurate with the significant risk of investing in an unproven company. Within this context, private equity managers have structured their partnerships to avoid the SEC's regulatory hurdles by limiting the investment in their funds to sophisticated institutional investors and wealthy individuals deemed not to need all of the protections of SEC mandatory disclosures.[5]

Because private equity managers issue partnership or shareholder interests in the fund to raise investment capital, and normally invest in private portfolio companies, they must comply with the 1933 Securities Act (the "1933 Act") and the 1934 Securities Exchange Act.[6] Private equity funds usually rely on statutory exemptions such as § 4(2) and Regulation D, under the 1933 Act, to avoid the costs and delays imposed by registration procedures and public disclosure requirements.[7]

Most private equity funds rely on Regulation D's Rule 506 exemption, which restricts each offering to an unlimited number of "accredited investors," and only 35 non-accredited investors who must be sophisticated or use a sophisticated purchaser representative.[8] An "accredited investor" must have an individual or joint spousal net worth of more than $1 million, or have more than $200,000 in annual income in each of the two most recent years, or joint income with a spouse in excess of $300,000.[9] The small investor is unlikely to meet the "accredited investor" requirement. Thus, he is precluded from directly investing in private equity.

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Private equity funds also fall under the purview of the

Investment Company Act of 1940 (the "1940 Act"), which requires the registration of an investment company.[10] Private equity firms frequently use the § 3(c)(1) exemption in the 1940 Act.[11] The § 3(c)(1) exemption essentially compels the funds to structure themselves as limited partnerships with fewer than 100 investors, which ultimately promotes the access of the wealthiest investors to venture investing.[12]

Private equity firms also rely on exemptions for investment funds that provide financial or managerial assistance to businesses as long as relevant conditions are met. "All the investors must be *accredited* investors as defined in § 2(a)(15) of the Securities Act of 1933."[13] The same is true for investment companies whose securities are owned by "*qualified* purchasers" and

are not publicly offered.[14] Under the latter exemption,[15] for an individual to be a "qualified purchaser," he must own at least $5 million in investments.[16] Thus, within this regulatory scheme, the typical private equity fund will err conservatively by excluding the small investor who does not meet the definitions of "accredited" or "qualified" in order to maintain the exemptions from the 1933 and 1940 Acts, and thereby minimize the costs associated with compliance.

II. Why Exclude the Small Investor?

THE SMALL INVESTOR'S GENERAL LACK of both investment expertise and significant capital reserves compels most private equity professionals run the other way. The common perception is that the small investor is not prepared for the illiquidity of private equity investments, the 10 to 13 year investment horizons, the absence of dividends, the potentially high degree of leveraging, and the probability of great returns *and devastating losses*.[17] Moreover, the typical small investor who is familiar with stocks and bonds may not be ready for investment vehicles for which daily performance updates and stock prices are impractical or nonexistent. The waiting period between the acquisition and the investment's liquidation may be too unpleasant and unpredictable for the small investor to bear for more than a few years.[18]

Given the existing regulatory framework and the assumptions regarding the small investor's lack of sophistication and disposable capital, his inclusion would hinder the efficient operation of private equity funds. Alternatively, by inducing private equity managers to eschew the small investor, the current regulatory regime creates a vicious cycle that has deprived the small investor of the investment experience necessary to understand the mechanisms of private equity.

Suppose a private equity firm relying on a Regulation D exemption were to include the small investor in the investment of a portfolio company. The small investor would lack not only the capital, but also the experience and knowledge, to negotiate adequately favorable terms for himself as a limited partner, or engage in due diligence and undertake a contractual liability scheme that would counteract any tendency on the part of the issuer to ignore the mandatory disclosure provisions of the securities laws.[19]

More significantly, the small investor is unlikely to be able to properly assess a start-up's real potential and associated risks. He may not comprehend how much time, money, and expertise it will take to achieve optimal liquidity. If disappointed, he may take legal action against the company, other investors, or even the company's managing partners. As a consequence, the private equity professionals may find his inexperience and threats to sue inconveniently burdensome in subsequent financing rounds. The potential for liability cuts into the efficient operation of the private equity firm.[20]

The inclusion of the small investor upsets the scheme to which private equity managers are accustomed. In this scheme, the investors are assumed to be sophisticated enough to negotiate favorable terms and conditions in the partnership agreement, and then sit back during the unsightly "in-between" periods of the investment. Furthermore, given the 100-investor limit that is necessary for the fund to maintain the § 3(c)(1) exemption from the 1940 Act, from costly and time-consuming registration requirements, seasoned institutional investors who contribute most of the funding for such investments typically do not want "individual co-investors other than very wealthy families"[21] who are deemed "accredited" and "qualified"

investors. To the extent that the SEC maintains its stance that *non-accredited* investors need the protections of the securities laws, and to the extent that the private equity community equates the small investor with a lack of disposable investment capital and sophistication, the small investor will be an impediment to the smooth running private equity machine.

III. Would Private Equity Professionals Want The Small Investor's Money?

In one camp, the cynics hold fast to the notion that even if the small investor were a wealthy individual, unless he is a "well-connected multimillionaire," no recognized venture capital fund will solicit his investment.[22] The small investor's relative inexperience and risk-aversion, compared to the traditional private equity investors, disqualify him from consideration.

As in the early years of venture financing, general partners would have to play a "missionary role" of handholding the small investor and explaining the desirability of enduring great risks for high returns.[23] What was once an unfamiliar concept to wealthy investors and institutions in the 1940s, now becomes a lesson for the small investor: "[W]hy it [is] desirable to purchase an existing business, often in a low-growth, mundane industry, that immediately [will] become heavily indebted to pay for its own acquisition–and that then [will], amazingly, use its own cash flow to unencumber itself from that debt."[24] The small investor will have to be instructed on the limited partnership structure, but his unfamiliarity with the industry puts him at a disadvantage in the process of negotiating the terms and conditions of limited partnership agreements.[25] Without the experience and knowledge of private equity investing, comparable to that of institutional and wealthy individual investors, the small investor is likely to be less effective than experienced investors when campaigning to revise partnership terms and conditions to eliminate provisions that are undesirable.[26]

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There are other practical factors that explain why private equity professionals might not want the small investor's money. One problem is oversubscription, when there is too much money chasing a finite number of deals, which exists even within the context of sophisticated investors. Oversubscription may become more apparent with the inclusion of the small investor. General partners may have trouble finding profitable places to invest, especially if the goal is to specialize efficiently.[27] This will depress the fund's internal rate of return, which means lower profits for the investors.

A second problem involves raising multiple funds. Marketing efforts directed to qualified investors already consume precious time and money. Imagine how the even greater costs incurred in wooing the small investor in addition to the seasoned investors might ultimately outweigh any perceived benefits. To attract the small investor, general partners may have to devote more time and capital upfront to account for additional disclosure requirements and marketing efforts, which will distract from managing the existing fund.[28] Additionally, both the more experienced limited partners and the general partners recognize that such fund-raising distractions compromise the general partners' main task of earning investment returns.[29]

In the other camp, the optimists (or opportunists) see the benefits of allowing the small investor to participate in the private equity sector, by employing some of the strategies currently used by private equity experts to share a portion of the potential returns with average investors.[30] Recognizing that the small investor currently has limited opportunities to gain exposure to venture investments, some financiers have devised ways to include individuals who are typically excluded from the private equity market.[31] The result has been the creation of special investment vehicles that merge aspects of private equity with public funds.

The former CEO for the University of North Carolina's endowment created the Endowment Fund,[32] which resembles a

"fund of funds" that diversifies by providing "all-in-one market exposure."[33] The difference between this investment vehicle and the typical private equity fund lies in its inclusion of private equity assets.[34] Despite its goal to include the small investor, the Endowment Fund is still limited to investors who must contribute a $100,000 minimum. Such individuals are wealthy, but lack the requisite clout to participate in institutional-class investment opportunities or topflight financial management.[35]

Although not quite "private equity" in the purest sense, the public fund hints at a willingness, within a segment of the private equity industry, to include the small investor. Some private equity firms such as Kohlberg Kravis Roberts & Co. and The Blackstone Group have launched public funds.[36] Proponents see them as vehicles to take advantage of the middle-market opportunity when big deals are scarce.[37] The public funds offer managers a chance to escape the frustrating, "crowded conditions in the core business of putting large sums" into leveraged buyouts and the "wearying cycles" of private funds.[38]

> "The pooled investment vehicle . . . appears to be the latest compromise that allows the private equity industry to include 'mom-and-pop investors,' without raising regulatory red flags."

Skeptics, however, refer to the popularity of public funds as an opportunistic phase of another investment bubble that brings larger returns to the managers than to the investors.[39] Admittedly, the high yields for the small investor come at no small cost.[40] Investors in the public funds must pay a minimum of 2% in management fees and a 20% incentive fee on dividends and interest, in addition to 20% of net capital gains; investors in the initial offer must hand over at least 7% in underwriting fees.[41] The downside for the small investor in this scene is that although the sponsors of these public funds may benefit almost as much as they would in a typical private equity setting, the shareholders may not.[42]

The idea of including the small investor is not something new. Yet, the private equity industry as a whole is not yet ready or willing to tap directly into that growing source.[43] The pooled investment vehicle, however, appears to be the latest compromise that allows the private equity industry to include "mom-and-pop investors," without raising regulatory red flags.[44]

Despite the small investor's desire for significant returns, the legal and practical[45] hurdles for the lawyers and private equity fund organizers are still an overriding concern.[46] While the more progressive players have given serious thought to devising means of drawing other sources of capital,[47] the prevailing sense is that the small investor is still not equipped with the capital reserves, expertise, or patience to deal with the steep fees, illiquidity, and high risks associated with private equity investments.[48] Furthermore, even the small investor with sufficient capital, may still not meet the needs of the entrepreneurs who seek the financial *expertise* that has traditionally come with private equity and venture capital.[49]

IV. Should the SEC Change its Rules on Qualified Investors?

THE INTERPLAY BETWEEN THE SECURITIES laws and the investing community over the years reflects the need to strike a delicate

balance between addressing the policy concerns of investor protection and promoting efficient capital formation and economic progress.[50] The private equity sector's exclusion of the small investor is based on the assumption that he is intolerant of risk and lacks both the necessary capital and sophistication. However, to the extent that the small investor has the money to invest and adequate information to make an informed decision, it may make sense to modify the current rules on qualified investors in private equity to give the small investor a chance.

One way of changing the current rules would be to lower the "accredited" and "qualified" investor criteria, so that *more*

investors, who currently cannot meet the $200,000 per annum income and $5 million investment thresholds required by Regulation D's Rule 506 exemption, may qualify for venture capital investment opportunities.[51] In order to offset the risks of fund insolvency and misaligned interests of general partners, there would need to be certain income and investment thresholds for the managers and directors of venture funds.[52]

In modifying the current rules to include the small investor, it is necessary to re-evaluate the Depression-era assumptions underlying the current scheme of securities regulation. As long as the small investor receives sufficient information upon which to evaluate the risks, there will be fewer reasons to exclude him, especially when he already has the freedom to invest his money in day-trade options, stocks on margin, and futures on commodities, which are just as, if not more, risky and volatile as private equity.[53] Some commentators even suggest that the concerns over allowing the small investor access to venture investing despite the high risks and his relative lack of sophistication, are understandable but overblown, especially since venture-backed stocks have outperformed the major indices and shown less volatility.[54]

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Nevertheless, an important caveat must be made to ensure that the modified rules still require the "small investor" to have a degree of investment sophistication. Although the small investor may have the money to invest, he still needs to understand what he is getting into. In order for the private equity machine to function efficiently, the investors need to possess the "ability to evaluate and assume risk."[55] But this is a challenging expectation of investor sophistication that few experts are willing to bank on.

V. Should the SEC Then Offer More Protections to the Small Investor?

THE SEC MUST BE CAUTIOUS not to over-regulate, and thereby short-circuit market efficiencies. Arguably, the existing framework of securities regulation already offers sufficient protections to the small investor by indirectly excluding him from the private equity industry. The federal securities laws protect investors against fraud and market manipulation.[56] The SEC also protects the small investor in the stock market by creating restrictions, such as the term "accredited investor." As long as the small investor fails to meet the income and investment requirements set forth by the "accredited" and "qualified" investor tests, he is excluded from private equity opportunities. The "accredited investor" test has been a point of contention among those who question its adequacy as a "proxy" to meet the "non-public" exemption requirements.[57] Neither the term "accredited," nor the term "qualified," says anything about investor sophistication. Despite this vague treatment of "sophistication," the SEC rules and regulatory exemptions have dictated the way private equity organizers have structured their funds to include only the wealthiest of individuals and institutions.

Regulation provides a greater benefit to the investor in the public market "where the connection between the business and the investor is more remote and the balance of power in corporate governance moves from the investor to the hands of the management."[58] It provides less of a benefit, however, in the private equity sphere where the parties are closer and have the means to negotiate terms.

Various commentators seem to agree that if there is to be more regulation, it ought to be simple and focused on measures that efficiently protect investors who cannot otherwise fend for themselves.[59] Regulation in the form of complicated and ambiguous doctrines and tests increases transaction costs and decreases market efficiency.[60] If the SEC finds that it must regulate the private equity industry more to protect the small investor, one approach should be to educate and inform the investing public about fraudulent market schemes and price manipulations.[61] Moreover, the SEC's approach here should be to target fraud against the small investor in the arena of private equity investments, instead of implementing broad and ambiguous rules that create costs that outweigh any perceived benefits.[62]

VI. Conclusion

THE REALITY OF THE PRIVATE EQUITY INDUSTRY, whose efficiency depends largely on the unhampered transactions between managers and sophisticated investors, is a financial hierarchy. One columnist humorously observed the class structure of the financial markets, describing it as one based on the prestige and likelihood of high returns and organized in the following order (from highest investment class to lowest): (1) private equity; (2) hedge funds; (3) high net-worth brokers/private banking; (4) ordinary brokers/mutual funds; and (5) bank deposits/mattresses.[63] This cynically suggests that the regulatory scheme, despite Congress's intent, has not succeeded in creating a level playing field for all investors. Indeed, it actually disguises the

inequity between the "ordinarily prosperous Americans" who typically invest in the more heavily regulated sectors like mutual funds, and the "very rich or very shrewd Americans," who invest in the more lightly regulated sectors, such as hedge funds.[64] Paradoxically, more regulation brings about further "financial class" stratification.

The move towards making private equity and venture capital more accessible to the small investor is a promising, but elusive, concept. If the small investor has enough money to invest, and is informed of and prepared to assume the risks, the reasons for excluding him seem less compelling. But, the costs of mandating disclosures to keep the small investor fully informed make it doubtful that private equity managers will readily welcome him. Most private equity managers assume that the small investor is not, nor ever will be, ready to stomach such high risks for high returns. Until the public is properly educated about financial instruments, the risks, and mechanisms of private equity, the financial class structure of the market will remain intact.

Part of the success of private equity rests on its "behind-the-scenes" and exclusive characteristics, which may not mix well with mandated transparency and over-regulation.[65] For the most part, the investing public is ignorant of private equity, and may not understand that much investment goes into small, unproven companies and older, less attractive, distressed companies that prefer to restructure "out of public view."[66]

Even if the private equity industry were to overcome successfully its initial reservations about the small investor's lack of expertise, and consequently wanted his money, the SEC would be pursuing ever closer at its heels. If regulators could target reforms to pinpoint fraud without compromising market efficiency, then the small investor should be permitted to invest directly in private equity. But given the imperfections of the current regulatory scheme, and the premium placed on market efficiency, it seems infeasible to allow the small investor to invest directly in private equity funds. BLB

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ENDNOTES: *Isadora Lee*

1 Permanence of Dividends, Capital Gains Tax Reductions: SIA Talking Points–Elimination of Personal Income Tax on Dividends is Good Pro-Growth Policy, *at* http://www.sia.com/TaxIssues/html/talking_points.html (last visited Aug. 24, 2005).

2 *Investor Protection Issues Regarding the Regulation of the Mutual Fund Industry: Hearing Before the U.S. Senate Committee on Banking, Housing and Urban Affairs* (Apr. 8, 2004) (testimony of Chairman of U.S. Sec. & Exch. Comm'n William H. Donaldson), *available at* http://sec.gov/news/testimony/ts040804 whd.htm (last visited Aug. 24, 2005).

3 Although not specifically defined, "sophistication" is obliquely alluded to in Rule 501's definition of "purchaser representative," who "[h]as such knowledge and experience in financial and business matters that he is capable of evaluating…the merits and risks of the prospective investment." 17 C.F.R. § 501 (2003).

4 The Investor's Advocate: How the SEC Protects Investors and Maintains Market Integrity, Introduction – The SEC: Who We Are, What We Do, *at* http://www.sec.gov/about/whatwedo.shtml (last visited Aug. 24, 2005).

5 Andrew R. Brownstein, Mitchell S. Presser & David E. Shapiro, *Private Equity Funds: Legal Analysis of Structural, ERISA and Securities Issues* 1, 14 [hereinafter *Private Equity Funds*].

6 *Id.* at 23-24. The 1933 Act requires all securities offered or sold to be registered with the SEC, unless the securities or their issuance falls within a regulatory exemption.

7 *Id*. This type of fund may rely on Section 4(2) for private placements and Regulation D (usually Rule 506 because of the unlimited dollar amount and unlimited number of investors).

8 JACK S. LEVIN, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS § 2-22 (1994). To maintain this exemption, private equity funds must disclose information to non-accredited investors and are prohibited from engaging in advertising and "general solicitation" of investors. *See Private Equity Funds*, *supra* note 5, at 24-25.

9 *See* Levin, *supra* note 8, at § 2-22. The "accredited investor" must also reasonably expect an income in excess of such amount in the current year.

10 *See* Duke K. Bristow, Benjamin D. King & Lee R. Petillon, *Venture Capital Formation and Access: Lingering Impediments of the Investment Company Act of 1940*, 2004 COLUM. BUS. L. REV. 77, 85-87 (2004) [hereinafter Bristow, King & Petillon] (explaining that the 1940 Act was intended to target mutual funds, which "primarily engage" in investing in securities, in contrast to private equity and venture capital firms, which may not necessarily "directly engage in the businesses of the portfolio companies that they control"). An investment company is defined as a company that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." *Id.*

11 *See id.* at 87. Section 3(c)(1) exempts a company with outstanding securities beneficially owned by not more than 100 persons that does not make a public offering of its securities.

12 *See id.* at 87-88 (commenting that if one assumes an average fund size of $93.8 million with each of 100 limited partners contributing equally, the average limited partner needs to put in roughly $1 million, which requires wealth liquidity "greater than the accredited investor requirements of $200,000 per annum income or $1 million net worth…which could [then] reduce the number of investors significantly below a hundred.").

13 Bristow, King & Petillon, *supra* note 11, at 92-93.

14 *Id.* at 95. *See* 15 U.S.C. § 80a-3(c)(7) (2000).

15 15 U.S.C. § 80a-3(c)(7) (2000).

16 Bristow, King & Petillon, *supra* note 11, at 95.

17 *See* Kara Scannell, *Should Investors Jump In If Private-Equity Funds Open Up?*, WALL ST. J., Feb. 27, 2001, at C1 (quoting an executive who "concede[s] that small investors won't likely stomach the illiquid and highly risky nature of such investing.").

18 *See* George L. Majoros, Jr., *The Development of "PIPEs" in Today's Private Equity Market*, 51 CASE W. RES. L. REV. 493, 496 (commenting on the problems of private investments in public equity due to their transparency). Majoros states that "LBOs are unfortunately like sausage. It tastes good, but you do not want to see how it is made. Private equity fund managers ordinarily would not want investors to watch the 'in-between' period, from the time the acquisition is made until the time you sell out or take it public. Why? Because there are a lot of things that can go wrong over the short term, that ultimately get corrected." *Id.*

19 *See* Merritt B. Fox, *Company Registration and the Private Placement Exemption*, 51 CASE W. RES. L. REV. 455, 469 (2001) (discussing the justifications for creating an exemption for the issuer in the case of sales of securities to one or a few institutional investors). Fox recommends such an exemption "because such purchasers can negotiate private arrangements with the issuer that effectively meet the concerns that call for imposing liability on the issuer for public sales in the first place." *Id.* at 471.

20 *See* John C. McIlwraith, *The Outlook for the Private Equity Market*, 51 CASE W. RES. L. REV. 423, 433-34 (2001) (noting that such widespread dissemination of "private" placement memoranda for financings over the Internet is often in violation of the "no public offering" restrictions imposed by 1933 Act's safe harbor exemptions).

[21] Duke K. Bristow & Lee R. Petillon, *Public Venture Capital Funds: New Relief From the Investment Company Act of 1940*, 18 ANN. REV. BANKING L. 393, 394 (1999) [hereinafter Bristow & Petillon].

[22] *See* Bob Sechler, *Fund Offers Smaller Investors Big Clout*, WALL ST. J., July 7, 2004 (quoting the national director of venture capital research for PricewaterhouseCoopers, who stated "that venture capitalists 'want institutional investors, they don't want individuals' who may lack patience or financial sophistication.").

[23] PRIVATE EQUITY PARTNERSHIP TERMS AND CONDITIONS § 1, 17 (David Toll ed., 2d ed. 2001) [hereinafter PRIVATE EQUITY].

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] WILLIAM MERCER, KEY TERMS AND CONDITIONS FOR PRIVATE EQUITY INVESTING 1, 68 (1996).

[28] *See id.* at 51 ("Marketing efforts and raising capital are distractions from the fund that may lead to additional revenue for the general partner and future limited partners but do little to help limited partners in existing funds…efforts to get the new capital invested can dilute the resources previously focused on the existing partnership investments.").

[29] PRIVATE EQUITY, *supra* note 23, at 23.

[30] *See* Sechler, *supra* note 22 (describing the Endowment Fund, which "aims to provide relatively small investors–albeit those able to pony up at least $100,000–exposure to the asset class, as well as overall diversification and management expertise on par with top university endowments.").

[31] *Id.*

[32] *See id.* (noting that the Endowment Fund grew to more than $220 million in assets in July of 2004, from roughly $40 million at its inception in April 2003).

[33] *Id.*

[34] *See id.* (reporting that the Endowment Fund includes "asset classes typically off limits to all but the most well-heeled investors, in addition to domestic and foreign stocks and bonds" and may "invest as much as 20% of its assets in private equity, such as venture capital funds, and it also invests in funds that deploy arbitrage or hedging strategies in attempts to reduce volatility or generate 'absolute returns' independent of financial markets."). In July 2004, the fund allocated 1.5% of its assets to private equity. *Id.*

[35] *Id.*

[36] *See* Henny Sender & Dennis K. Berman, *Private Equity Goes to Public, Letting Small Investors Play*, WALL ST. J., Apr. 26, 2004, at C1 (describing the public funds that primarily invest in the debt of private, medium-size companies and promise relatively high yields in the current low-interest rate setting).

[37] *Id.*

[38] *Id.*

[39] *See id.* ("By contrast with the conventional private equity funds, these new public funds don't have to return capital to investors…[the managers] will be pocketing generous fees.").

[40] *See id.* (quoting a founder of a private-equity fund, who has no plans to sponsor a public fund: "Ordinary investors are being asked to pay private-equity-type fees for single-digit returns.").

[41] *See* Sender & Berman, *supra* note 36 (explaining that in these closed-end funds with private equity-type fees, the investors are "down as much as 10 cents.").

[42] *See id.* (quoting an executive of a public firm who states that the compensation structure of private-equity firms may serve the sponsors better than the shareholders).

[43] *See* Scannell, *supra* note 17 (describing how some private equity firms are selling stakes to investors with large individual-shareholder bases, such as pension funds, but not directly to investors). The article cites that "individual investors are a growing pool with more than $1.7 trillion invested in 401(k) retirement accounts. *Id.* However, the means by which 401(k) plans would someday be incorporated via pooled investments is still unclear. *Id.*

[44] *See id.* (explaining that investment banks comply with securities laws by pooling funds of wealthy investors and investing them as one investor). *See also* Suzanne McGee, *Venture-Capital Plays for Ordinary Joes*, WALL ST. J., Aug. 8, 2000, at C1 (reporting on the closed-end fund MeVC Draper Fisher Jurvetson Fund I, which was the "first high-profile effort to open the doors of Silicon Valley venture-capital investing to the general public.").

[45] *See* Scannell, *supra* note 17 (observing that one of the practical barriers for the small investor is the steep 20% fees).

[46] *See id.* (quoting a partner at Debevoise & Plimpton who notes that the prevailing question is how to "repackage the private-equity fund investment so that it's legally suitable to be broken down into pure retail pieces.").

[47] *See* McGee, *supra* note 44 (describing MeVC, Tim Draper's concept of "venture-capital investing for the general public" which faces the problems of structural and regulatory limitations and new risks of failure due to the high fees resembling those charged by top venture-capital firms). Also problematic about MeVC was the fact that its partners' interests were not aligned with those of the fund investors. The partners did not have their own money at stake, were minimally involved as advisers, and still charged hefty management fees even though management was in the hands of a less-experienced venture investor. *Id.*

[48] *See* Scannell, *supra* note 17 (discussing how some firms have considered the idea of including the small investor, but have ultimately declined to add a "big new class of people" that might not be appropriate for the funds).

[49] *See* McGee, *supra* note 44 ("Entrepreneurs don't just want cash; they also want money from an investor who can bring management expertise, sales leads or introductions to bankers.").

[50] *See* Bristow, King & Petillon, *supra* note 10, at 121 (discussing the need to re-evaluate the outdated presumptions of securities regulation while balancing public policy concerns in a new era of private equity and venture capital).

[51] *See id.* (commenting on the controversial idea of removing the "accredited investor" criteria for § 6(a)(5) exempt funds, which may be a reasonable consideration for angel investors).

[52] *Id.*

[53] *See id.* at 125 (arguing that "venture capital funds may or may not constitute riskier investment vehicles").

[54] *See id.* at 119-20 (observing that the public has mischaracterized the venture capital market, which has "provided superior returns with less risk to investors, even after their public offerings…[and] that the market will correct for any over-allocation of capital."). The comment argues that venture capital is no more risky than other investment vehicles; it experiences booms and busts just like other business sectors and financial markets and constitutes "productive societal investment independent of cycles." *Id.* at 120.

[55] Bristow & Petillon, *supra* note 21, at 401.

[56] One such example is Section 10(b) under the Exchange Act of 1934, and Rule 10b-5 promulgated thereunder.

[57] *See* William H. Coquillette, *Private Equity, Capitalism, and Efficiency*, 51 CASE W. RES. L. REV. 479, 482 (2001) (explaining that the problems in private equity transactions usually arise from the mischaracterization of "accredited investors," whose definition is "not a good proxy for what is "non-public" in the private equity area.").

[58] *See id.* at 482 (stating that regulation is necessary in the public market to "maintain robust capitalism").

[59] *See, e.g.,* Joseph A. Grundfest, *The Ambiguous Boundaries Between Public and Private Securities Markets*, 51 CASE W. RES. L. REV. 483, 491 (2001) (commenting on how the ambiguous boundaries created by the integration doctrine for example, which, if aggressively interpreted by the SEC "can add to transaction costs without otherwise contributing to investor protection").

[60] *Id. See* Fox, *supra* note 19, at 457 (noting the costs associated with determining and policing the border between private and public sales); Ronald J. Coffey, *The Significance of Non-Publicness for Securities Interventions*, 51 CASE W. RES. L. REV. 473, 476 (2001) (discussing the "implementation cost" of curing information failures in making mandatory disclosures before the issuance of securities); Coquillette, *supra* note 57, at 482 ("Too many resources are used up…to police the separation from what is public and what is non-public.").

[61] *See* Bristow, King & Petillon, *supra* note 10, at 125-26 (advocating a regulatory approach that increases public awareness of fraud schemes and "tighten[s] enforcement [to] mitigate corruption without imposing such heavy regulatory burdens upon emerging companies and venture capitalists"). A recommended approach is to use "targeted efforts, as opposed to implementing unwieldy rules." *Id.* at 126.

[62] *Id.* at 126.

[63] *See* Michael Lewis, *No One Can Save Wall Street's Lower Class*, *available at* http://www.bloomberg.com/apps/news?pid=100000039&sid=a7WQcdj7fooU&refer=columnist_lewis# (last visited Aug. 24, 2005) (stating that "[o]rdinarily prosperous Americans invest their capital differently than very rich or very shrewd Americans.").

[64] *Id.*

[65] *See Private Equity: Parting the Veil*, ECONOMIST, Dec. 22, 2003, *available at* http://www.forbes.com/strategies/2004/08/20cx_sr_0820ipooutlook.html (last visited Aug. 24, 2005) ("Aside from the self-serving or understandable reluctance of private-equity firms to reveal more, there are also genuine conceptual difficulties in doing so. Ultimately, the only measure of a private-equity stake's value is what it fetches when it is sold. But a sale might be years away.").

[66] *Id.*