WHAT'S THE PROBLEM?: WHY INCREASED REGULATION FOR MUTUAL FUNDS MIGHT HURT BOTH PRIVATE FIRMS AND INDIVIDUAL INVESTORS

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I. INTRODUCTION

Investors looking to invest in private companies (at the time of this writing) such as SpaceX, WeWork, and AirBnB are normally out of luck. That is, unless they invest in specific vehicles such as the Fidelity Investments Contrafund, which purchases shares in all three of those companies.[1] This Note will argue that federal securities law should not

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1. The annual report lists each holding of the fund. *Fidelity Contrafund*, FIDELITY, https://fundresearch.fidelity.com/mutual-funds/composition/316071109?type=o-NavBar. (follow "Prospectus & Reports" hyperlink under "Fund Facts"; then follow "Annual Report" tab) (last visited Mar. 3, 2018).

interfere in the mutual fund industry and should maintain the current level of regulation regarding mutual fund investment in private companies. Investing in private companies may come with some risk, but investors can take advantage of diversification to reduce that risk. Some scholars have called for restrictions on mutual funds' abilities to invest in private companies, citing concerns such as inaccurate valuations, liquidity issues, and a lack of investor awareness. In addition to arguing that these issues are largely overblown, this Note contends that private companies, mutual funds, and even the investors themselves benefit more from the status quo level of regulation. There might be some truth to the argument that investors would not invest in funds that buy shares of private companies if investors knew that these funds were investing in private companies, but the percentage of holdings that make up private company investments within mutual funds is infinitesimal when compared to overall holdings.[2]

Part II reviews the necessary background information to this topic, beginning with the history of mutual funds and how mutual funds work. Additionally, this Part examines the Initial Public Offering ("IPO") problem, sometimes referred to as the death of the IPO,[3] and why companies are foregoing the opportunity to go public. Lastly, this Part discusses the current regulations that pertain to the mutual fund industry via the Investment Company Act.

Part III addresses current arguments in favor of increased regulation for the mutual fund industry when it comes to investments in private companies. Essentially, the argument goes, more regulation is required because retail investors lack an awareness that some of the funds they invest in may indirectly invest that money in private companies, which can be difficult to track.

Part IV explains, by contrast, why the current level of regulation results in an "everybody wins" scenario. Private companies, the mutual funds themselves, and investors all benefit by allowing mutual funds to buy shares of private companies. Capital formation suffers when regulatory costs increase—more money spent on compliance means the company has less for research, development, and production. These companies, particularly startups (less so for established, unicorn, and

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2. *See* KATIE REICHART, MORNINGSTAR, UNICORN HUNTING: MUTUAL FUND OWNERSHIP OF PRIVATE COMPANIES IS A RELEVANT, BUT MINOR, CONCERN FOR MOST INVESTORS 3, 13 (2016), https://perma.cc/RT6E-SPFA. Just to keep things in perspective, Morningstar has found that private firm holdings accounted for just 0.13%—or $11.48 billion—out of the mutual fund industry's $8.6 trillion as of 2016. *Id.* at 3.

3. *See* Dan Murphy, *The US IPO Market Is Dead, but ICOs Are the Future, Says Entrepreneur*, CNBC (Sept. 20, 2017, 9:08 PM), https://www.cnbc.com/2017/09/20/the-us-ipo-market-is-dead-but-icos-are-the-future-says-entrepreneur.html.

decacorn-like companies)[4] suffer where mandatory disclosure costs can hinder the development of nascent companies that are just trying to get off the ground. Individual investors also benefit from the current level of regulation. Investors are able to invest—albeit indirectly—in private companies such as SpaceX and AirBnB because these mutual funds invest in them on behalf of the investors.

This Note concludes by restating the reasons why increased regulation is not the answer, and poses the question of why securities law is different for investments in private companies than for other avenues where investors can lose everything if the wrong decisions are made.

II. BACKGROUND

A. History and Growth of Mutual Funds

The origins of the investment fund are relatively unknown—some scholars point to companies launched by the king of the Netherlands in 1822 as the first mutual funds, while others look to a merchant by the name of Adriaan van Ketwich, who founded an investment trust in 1774.[5] Following these initial endeavors, investment vehicles were launched in Switzerland in 1849 and then in Scotland in 1880.[6] Investment trusts were brought to the United States during the 1890s.[7] Like Ketwich's fund, these were often closed-end funds, i.e., they could only issue a fixed number of shares.[8] In 1924, however, the Massachusetts Investors Trust became the first open-end U.S. mutual fund, meaning the investment company managing the fund could continuously issue and redeem shares at prices that are proportional to the investment portfolio.[9]

Since then, the success of the mutual fund industry has increased extensively.[10] At the end of 2016, a little more than half of the U.S.

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4. Unicorns are private companies with a market value of $1 billion whereas decacorns are private companies worth at least $10 billion. Jillian D'Onfro, *There Are So Many $10 Billion Startups That There's a New Name for Them: 'Decacorns,'* BUS. INSIDER (Mar. 18, 2015, 9:42 AM), http://www.businessinsider.com/decacorn-is-the-new-unicorn-2015-3.

5. James McWhinney, *A Brief History of the Mutual Fund*, INVESTOPEDIA, https://www.investopedia.com/articles/mutualfund/05/mfhistory.asp (last updated Feb. 6, 2018).

6. *Id.*

7. K. Geert Rouwenhorst, *The Origins of Mutual Funds* 17 (Yale Int'l Ctr. for Fin., Working Paper No. 04-48, 2004), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=636146.

8. *Id.*

9. *Id.*

10. *See* INV. CO. INST., 2017 INVESTMENT COMPANY FACT BOOK 28, 240–41 (57th ed. 2017) [hereinafter 2017 ICI FACT BOOK], https://www.ici.org/pdf/2017_factbook.pdf (finding that in 2016, the U.S. mutual fund industry held $16.3 trillion in assets).

mutual funds were made up of equity funds, with bond funds coming in second.[11] Retail investors—generally small-scale investors, such as households—hold a very large majority percentage of the total assets in the mutual fund industry.[12] For many retail investors, retirement seems to be a key objective.[13] While retirement is certainly important, retail investors use mutual funds to accomplish other financial goals, including saving for emergencies and education, as well as reducing taxable income.[14]

Despite the numbers surrounding these holdings, overall demand for mutual funds as measured by net new cash flow (sales of new funds minus redemptions plus net exchanges) declined in 2016. A number of factors including reformed regulations for money market funds, shifting demographics, and higher demand for indexed goods all seem to be at least partly responsible for the decline in demand for mutual funds.[15] However, in spite of the slight decrease in demand, cash flows into longer-term mutual funds tend to see more moderate changes even in the face of market fluctuations and downturns. One reason for this may be because retail investors have a longer-term time horizon than do institutional investors.[16] Because a large percentage of mutual fund shares are purchased through employer-sponsored retirement plans, these shares are purchased without the individual investor having to consciously purchase them.[17] This results in a relatively constant purchasing of shares. Additionally, many retail investors turn to financial advisers to guide them in the market. These professionals tend to provide an objective, steadying influence over the retail investor during times when the market may be experiencing a slight decrease in prices.[18] Perhaps another reason for the popularity of mutual funds stems from the fact that many retail investors can own mutual funds with a fairly moderate income. In 2016, the median household income of

11. *Id.* at 28.
12. *Id.* at 30. To more easily put it in perspective, out of that $16.3 trillion, retail investors held as much as 89% of the total assets in the mutual fund industry, which is as much as $12.9 trillion. *Id.*
13. INV. CO. INST., CHARACTERISTICS OF MUTUAL FUND INVESTORS 1, 8 (2017), https://www.ici.org/pdf/per23-08.pdf (finding that an overwhelming majority of people (92% of those who participated in the survey) use mutual funds to save for retirement, with 75% of people indicating that mutual funds were the primary method for retirement savings).
14. *Id.* at 8.
15. 2017 ICI FACT BOOK, *supra* note 10, at 31.
16. *Id.* at 33.
17. INV. CO. INST., *supra* note 13, at 9.
18. 2017 ICI FACT BOOK, *supra* note 10, at 33.

those who owned mutual funds was $100,000.[19] Mutual funds are also accessible by a wide array of people with different demographics. While the average age of those who were the head of a household that owned mutual funds was fifty-one, in 17% of households that owned mutual funds the head of household had not yet reached their thirty-fifth birthday.[20] Although the number of mutual funds has shrunk since the peak of 8300 funds at the end of the dot-com bubble in 2001, a robust approximate 8000 different mutual funds still exist as of 2017.[21]

B. How Mutual Funds Work

Before attempting to explain how mutual funds operate, it may be useful to precisely define the term. The Securities and Exchange Commission ("SEC") defines the term mutual fund as "an SEC-registered open-end investment company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments."[22] Similar to a stock portfolio which is made up of all the different individual stocks that an investor might own, the combination of assets that the mutual fund owns is its portfolio which is managed by an investment adviser who is registered with the SEC.[23] Mutual funds issue and redeem shares at a price—called the net asset value ("NAV") because it represents assets minus liabilities—which is calculated at the end of the trading day.[24] A fund sponsor, normally some kind of institutional investor such as the Vanguard Group, organizes the fund.[25] This sponsor then collects money from the public who would like to invest in that particular fund and then invests the money that was raised into different securities that fall in line with the investment objective of the fund.[26] Sometimes investors can purchase shares directly from the fund,

19. INV. CO. INST., *supra* note 13, at 5. Furthermore, 16% of mutual fund-owning households had a median income of less than $50,000. *Id.*

20. *Id.* at 2.

21. Mark P. Cussen, *How Big is the Mutual Fund Industry?*, MUTUALFUNDS.COM, http://mutualfunds.com/education/how-big-is-the-mutual-fund-industry/ (last updated Aug. 29, 2017).

22. OFFICE OF INV'R EDUC. & ADVOCACY, U.S. SEC. & EXCH. COMM'N, SEC PUB. NO. 182 (12/16), MUTUAL FUNDS AND ETFS: A GUIDE FOR INVESTORS 4 (2017).

23. *Id.*

24. *Id.*; *see also* D. Bruce Johnsen, *Myths About Mutual Fund Fees: Economic Insights on* Jones v. Harris, 35 J. CORP. L. 561, 566 (2010).

25. Richard Loth, *How a Mutual Fund Works*, INVESTOPEDIA, https://www.investopedia.com/university/quality-mutual-fund/chp1-introduction/mf-structure.asp (last visited Mar. 3, 2018).

26. *Id.*

but normally shares are bought through some sort of intermediary, usually a broker or investment advisor.[27]

As opposed to investing in individual stocks, mutual funds offer the retail investor numerous advantages. First, mutual funds may provide diversification.[28] By diversifying one's portfolio, the investor can manage "nonsystematic risk" by buying into many different sectors at once.[29] Indeed, the diversification that mutual funds offer is so advantageous because "[u]nless you have considerable funds to invest, it would likely be impractical for you to take on shares of as many different companies as the fund can."[30] The Vanguard Group, one of the largest institutional investors on the planet, describes diversification as follows: "If you can't find the needle, buy the haystack."[31] Mutual funds may also help reduce transaction costs by taking advantage of the size and purchasing power of the fund. When an investor buys shares in a mutual fund, he saves the money he would have spent on transaction fees had he just bought the individual stocks located within the fund. This is sometimes referred to as "economies of scale."[32] Additionally, as briefly mentioned earlier, a third advantage of mutual funds is that they offer the services of a professional portfolio manager. These professionals are often experienced money managers who can make decisions regarding asset allocation within the fund that are justified by current market conditions, as well as ensure that the mutual fund is operating according to its prospectus.[33]

However, perhaps the greatest disadvantage to owning mutual funds is the fees and expenses that can be incurred. There remains a distinction between shareholder fees and operating expenses. Shareholder fees are costs that are associated with a particular transaction.[34] The firm takes operating expenses out of the assets within the fund instead of imposing

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27. *Id.*

28. *See* INV. CO. INST., A GUIDE TO UNDERSTANDING MUTUAL FUNDS (2007), https://www.ici.org/pdf/bro_understanding_mfs_p.pdf. However, industry-specific mutual funds are not necessarily diversified.

29. *See Diversifying Your Portfolio*, FIN. INDUSTRY REG. AUTHORITY, http://www.finra.org/investors/diversifying-your-portfolio (last visited Mar. 3, 2018).

30. ALAN NORTHCOTT, THE MUTUAL FUNDS BOOK: HOW TO INVEST IN MUTUAL FUNDS & EARN HIGH RATES OF RETURNS SAFELY 104 (2009).

31. *Diversification: There's No Crystal Ball*, VANGUARD, https://investor.vanguard.com/investing/how-to-invest/diversification (last visited Mar. 3, 2018); *Who We Are*, VANGUARD, https://about.vanguard.com/who-we-are/ (last visited Feb. 2, 2019).

32. Barclay Palmer, *The Advantages of Mutual Funds*, INVESTOPEDIA, https://www.investopedia.com/investing/advantages-of-mutual-funds/ (last updated Mar. 27, 2019).

33. JOHN A. HASLEM, MUTUAL FUNDS: PORTFOLIO STRUCTURES, ANALYSIS, MANAGEMENT, AND STEWARDSHIP 39 (2010).

34. OFFICE OF INV'R EDUC. & ADVOCACY, U.S. SEC. & EXCH. COMM'N, SEC PUB. NO. 162 (5/14), INVESTOR BULLETIN: MUTUAL FUNDS FEES AND EXPENSES (2014).

the operating expenses directly on the investor. However, because the fees are taken out of the fund's assets, the investors are paying for these operating expenses indirectly.[35] Additionally, management may take a fee that is paid out of the fund's assets for managing the fund's portfolio. Section 35(b) of the Investment Company Act of 1940 places a fiduciary duty upon fund managers relative to the fee such a manager may exact for his services.[36] Despite this language that shareholders of the fund are owed a fiduciary duty, the threshold to violate the duty is quite high.[37] Fees might seem like a relatively insignificant problem because the actual percentage is minuscule, but over time the amount of money an investor loses can add up. As an example, if an investor placed $100,000 in a mutual fund with an annual return of 4%, over the span of twenty years with an annual fee of .25% that investment would grow to approximately $210,000. Everything else being equal, moving the annual fee up to just 1% would reduce the value of the portfolio to about $180,000—nearly a $30,000 difference with a mere .75% increase in the annual fee.[38] Lured by the notion that high fees will guarantee high returns, many investors continue to invest in mutual funds that charge high fees despite evidence suggesting funds with low fees outperform those with high fees.[39]

C. The "IPO" and Why Firms Are Staying Private

Increasingly, companies are deciding not to go public. Indeed, some of the largest companies, those with valuations north of $10 billion, are opting to remain private.[40] One possible reason for this slowdown could be because "[i]nvestors have been more attracted to larger companies which are given a higher multiple at the time of their IPO. The companies with higher multiples have typically performed better from Day 1

35. *Id.*

36. 15 U.S.C. § 80a-35(b) (2012).

37. In *Jones v. Harris Associates L.P.*, the Supreme Court of the United States stated that in order for an investment adviser to face liability for a breach of fiduciary duty, the fee charged must be "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." 559 U.S. 335, 346 (2010).

38. *See* OFFICE OF INV'R EDUC. & ADVOCACY, U.S. SEC. & EXCH. COMM'N, SEC PUB. NO. 164 (2/14), INVESTOR BULLETIN: HOW FEES AND EXPENSES AFFECT YOUR INVESTMENT PORTFOLIO 1 (2016).

39. *See* Ian Ayres & Quinn Curtis, *Improved Performance Guarantees* 16 (Jan. 7, 2014), https://ssrn.com/abstract=2375842.

40. Trevir Nath, *Why Unicorns Like Uber and Airbnb Aren't Going Public*, NASDAQ (June 16, 2016, 9:44 AM), https://www.nasdaq.com/article/why-unicorns-like-uber-and-airbnb-arent-going-public-cm636292.

onwards."[41] This suggests that investors have previously been burned by some lackluster IPOs and may not want to incur the risk that comes from investing in what are normally smaller, less established companies. From a capital raising perspective, however, companies could be staying private because they simply do not need public money to finance projects and operations.[42] In 2014, the average age of technology companies that went public was eleven years. This is up from 1999 where the average age of technology firms going public was only four years.[43] In addition to the fact that investors like to give larger companies higher multiples at the time of their IPO, the Jumpstart Our Business Startups ("JOBS") Act greatly increased the number of shareholders a company can have before it even has to think about complying with mandatory financial statement disclosure regulations.[44] Further, private capital investment has taken off. In 2015, capital investment in private firms reached approximately $75 billion, which was up from about $26 billion in 2013.[45] Some companies that are choosing to remain private even have some liquidity options that are enabling employees to sell stock in their company before a potential IPO would even occur.[46] Operating in a public market can also act as a cost that some firms are unwilling to incur unless required.[47] While the JOBS Act seems to be alleviating at least some costs associated with going public, "soft costs—meaning things like fear of shareholder litigation or the pressure to impress Wall Street analysts on a quarterly basis" are still working their way into the minds of company executives.[48] Some firms may elect to stay private due to the allure of being a target for a merger or acquisition.[49] Additionally, firms with large amounts of

41. *Id.*

42. *Id.* "The private market has become flooded with capital from venture capitalists, financial institutions, and late stage investors. Even hedge funds have started to dabble in private deals because they generate better return prospects." *Id.*

43. Begum Erdogan et al., *Grow Fast or Die Slow: Why Unicorns are Staying Private*, MCKINSEY & COMPANY (May 2016), https://www.mckinsey.com/industries/high-tech/our-insights/grow-fast-or-die-slow-why-unicorns-are-staying-private.

44. *Id.*

45. *Id.*

46. Tom Zanki, *4 Reasons Cos. Are Staying Private Longer*, LAW360 (Mar. 14, 2017, 9:08 PM), https://www.law360.com/articles/901768/4-reasons-cos-are-staying-private-longer.

47. *See id.* In 2011, the U.S. Department of the Treasury concluded that an IPO can cost about $2.5 million, and even after the IPO is completed it can cost $1.5 million per year to comply with regulation. *Id.*

48. *Id.*

49. *See id.* It might seem strange that executives want to be bought out by other companies, but "[a] sale provides a faster and more certain exit for a company's shareholders without worrying about the volatility of public markets." *Id.*

intangible assets may find disclosure rules and Generally Accepted Accounting Principles ("GAAP") especially irritating.[50]

A brief foray into what an initial public offering is and why companies choose to go public may be helpful in understanding why some companies choose to remain private. To put it plainly, an IPO refers "to the first time a company offers its shares of capital stock to the general public."[51] In order to register an IPO with the SEC, the company looking to go public must file a registration statement.[52] One of the more important documents within this registration statement is the company's prospectus.[53] This document contains a description of the terms that are being offered with each type of security as well as disclosures from the company about its financial health, the business model of the company, and details on management.[54] Once the registration statement is filed, it is scrutinized by the SEC and reviewed for compliance with disclosure constraints.[55] Before the review is even complete, underwriters of the IPO—usually large investment banks such as Goldman Sachs—will begin to recommend prices to the issuer who will finalize the price per share of the IPO.[56]

There are many reasons why private firms may decide to go public. First, some academic data suggest that firms may go public in order to minimize the cost of capital by seizing external equity.[57] Secondly, an IPO may allow some early investors and insiders at the company the opportunity to cash out once the company is listed publicly.[58] Alternatively, IPOs can effectively create a "currency" which can be used to take over other companies without having to resort to spending exorbitant sums of money.[59] IPOs can also serve as a marketing

50. *See* Craig Doidge et al., *Eclipse of the Public Corporation or Eclipse of the Public Markets?* 10–11 (European Corp. Governance Inst., Finance Working Paper No. 547/2018, 2018), https://ssrn.com/abstract=3100255 (explaining that disclosing information reveals ideas that a private company may not want to give up).

51. OFFICE OF INV'R EDUC. & ADVOCACY, U.S. SEC. & EXCH. COMM'N, SEC PUB. NO. 133 (2/13), INVESTOR BULLETIN: INVESTING IN AN IPO 1 (2013).

52. *Id.*

53. *Id.*

54. *Id.* at 3.

55. *Id.* at 1.

56. *Id.* at 2.

57. James C. Brau & Stanley E. Fawcett, *Initial Public Offerings: An Analysis of Theory and Practice*, 61 J. FIN. 399, 405–06 (2006) (citing Franco Modigliani & Merton H. Miller, *Corporate Income Taxes and the Cost of Capital: A Correction*, 53 AM. ECON. REV. 433 (1963)).

58. *Id.* (citing Antonio S. Mello & John E. Parsons, *Hedging and Liquidity*, 13 REV. FIN. STUD. 127 (2000)).

59. *Id.* (citing James C. Brau et al., *The Choice of IPO Versus Takeover: Empirical Evidence*, 76 J. BUS. 583 (2003)).

opportunity for a company in an effort to increase the share price.[60] Another potential advantage is the discipline that being publicly listed imposes on management. However, perhaps the strongest argument for going public is indeed the option for early shareholders to cash out their holdings.[61] If managers are not performing adequately, shareholders can cash out and the stock price may drop, making the company ripe for a takeover bid that could threaten existing management.[62]

D. Current SEC Regulations for Mutual Funds

Securities law, and particularly the Investment Company Act of 1940, exists to protect the interests of investors.[63] The Supreme Court has stated that the Investment Company Act was born because Congress was afraid both the Securities Act of 1933 and the Securities Exchange Act of 1934 were insufficient to protect investors who sought to purchase securities from investment companies.[64] Because of the implications of securities law and the highly sensitive nature of investor protection, the Investment Company Act is one of securities law's most complex set of statutes:

> It places substantive restrictions on virtually every aspect of the operations of investment companies: their valuation of assets, their governance and structure, their issuance of debt and other senior securities, their investments, sales and redemptions of their shares, and, perhaps most importantly, their dealings with service providers and other affiliates.[65]

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60. *Id.* (citing Vojislav Maksimovic & Pegaret Pichler, *Technological Innovation and Initial Public Offerings*, 14 REV. FIN. STUD. 459 (2001)).

61. Richard A. Booth, *The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships*, 32 WAKE FOREST L. REV. 79, 91 (1997) ("The beauty of going public is that one can sell off a few shares without giving up control. Indeed, this 'have-your-cake-and-eat-it-too' aspect may well be the strongest motivation for going public.").

62. *Id.* at 90.

63. 15 U.S.C. § 80a-1(b) (2012) ("It is declared that the policy and purposes of this subchapter, in accordance with which the provisions of this subchapter shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.").

64. *See* United States v. Nat'l Ass'n of Sec. Dealers, Inc., 422 U.S. 694, 704 (1975).

65. Paul F. Roye, Dir., Div. of Inv. Mgmt. U.S. Sec. & Exch. Comm'n, Remarks Before the American Law Institute/American Bar Association at the Investment Company Regulation and Compliance Conference (June 19, 2003), https://www.sec.gov/news/speech/spch061903pfr.htm.

The Investment Company Act codifies many of the powers granted to the SEC for regulating the mutual fund industry. For example, mutual funds must: register with the SEC;[66] register each and every security that they plan to sell to investors;[67] and submit to the SEC copies of the literature sent to prospective investors so that it can be reviewed.[68] The Investment Company Act also requires mutual funds to disclose and periodically update financial statements as well as distribute "at least semiannually" a myriad of financial reports to shareholders of the fund to explain the performance of the mutual fund.[69] Although subject to what seems like endless regulation, the justification is that the regulation is necessary because mutual funds are organized and run by investment advisers who may have a potential conflict of interest since they have their own shareholders to appease.[70] For this reason, Congress decided that 40% of a mutual fund's board of directors needs to be independent directors who have little to no contact with the mutual fund.[71] Keeping in mind the goal of securities law—to protect investors—the SEC's Division of Investment Management conducted a study of how mutual fund governance was performing in 1992. The study concluded:

> The oversight function performed by [mutual fund] boards of directors, especially the "watchdog" function performed by the independent directors, has served investors well, at minimal cost. In [the Division's] view, however, the increasingly significant responsibilities placed on independent directors warrant a few changes to further strengthen their independence. Accordingly, the Division recommends that the Commission recommend legislation that would increase the minimum proportion of independent directors on [mutual fund] boards from forty percent to more than fifty percent. In addition, the Division recommends

66. *See* 15 U.S.C. § 80a-8 (2012).
67. *Id.* § 80a-24(a).
68. *Id.* § 80a-24(b).
69. *Id.* § 80a-29(e).
70. Jerry W. Markham, *Mutual Fund Scandals—A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments*, 3 HASTINGS BUS. L.J. 67, 78–79 (2006).
71. Martin E. Lybecker, *Enhanced Corporate Governance for Mutual Funds: A Flawed Concept That Deserves Serious Reconsideration*, 83 WASH. U. L.Q. 1045, 1050 (2005) (citing 15 U.S.C. § 80a-10(a)).

> that independent director vacancies be filled by persons chosen by remaining independent directors.[72]

Despite this increase in the number of independent directors, various scandals exposed the need for further regulation,[73] and the Corporate Governance Amendments were enacted in 2004. These amendments raised the independent director requirement to 75% of the total number of directors on the board of a mutual fund.[74] As is evident, the Investment Company Act was enacted to protect the interests of investors who may not be savvy enough to understand the intricacies of the mutual fund industry. Increasing the number of independent directors, as well as the heightened level of disclosure that mutual funds must adhere to, have all been steps with that goal in mind.

As far as mutual fund investment in private companies is concerned, various restrictions exist. Recently, the SEC has adopted rules for mutual funds and liquidity risk. According to the SEC:

> The new rules will enhance the quality of information available to investors and will allow the Commission to more effectively collect and use data reported by funds. The new rules also will promote effective liquidity risk management across the open-end fund industry and will enhance disclosure regarding fund liquidity and redemption practices.[75]

In addition, the new rules strengthen the restriction that a maximum of 15% of a fund's holdings can be in illiquid investments. These new rules are intended to require "enhanced disclosure regarding fund liquidity and redemption practices."[76] In sum, mutual funds will likely need to provide some more information about the liquidity risks attached to their holdings. Investments in private companies are going to be considered illiquid because shares in those private companies cannot be traded on public markets.

72. *Id.* at 1058 (alterations in original) (quoting DIV. OF INV. MGMT., U.S. SEC. & EXCH. COMM'N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 253–54 (1992)).
73. *See generally id.* at 1061–79.
74. *Id.* at 1080.
75. *SEC Adopts Rules to Modernize Information Reported by Funds, Require Liquidity Risk Management Programs, and Permit Swing Pricing*, U.S. SEC. & EXCH. COMM'N (Oct. 13, 2016), https://www.sec.gov/news/pressrelease/2016-215.html.
76. *Id.*

III. THE ARGUMENT FOR INCREASED REGULATION

The argument for limiting mutual fund participation in private companies centers around three main pillars: (1) investor awareness, (2) redemption rights, and (3) misplaced valuations. In order to understand why increased regulations for mutual funds would be harmful to investors in the long term, it is first necessary to understand the arguments in favor of increased regulation, particularly when it comes to those funds that invest in private companies and, specifically, startups and unicorns.[77] The argument for further regulation attempts to mitigate three primary concerns. First, investors may not be aware that the mutual funds in which they have purchased shares are potentially investing in these private firms. Second, investors are able to redeem shares in their fund and realize the gains fairly quickly. With private companies, because they do not trade shares on a public market, there may be some liquidity concerns with redeeming these fund shares. Third, the valuations that the fund managers place on those they manage may be inaccurate.[78]

Ilya Strebulaev, a professor at Stanford, has echoed these concerns of mutual funds potentially assigning inaccurate valuations, stating that "[mutual fund companies] are sophisticated in the public markets but they are inexperienced in the private markets."[79] There is even some data to suggest that these funds could be subject to runs—a quick outflow of capital—if investors become too wary about the valuations of their illiquid holdings since they are of private companies.[80] Further, when it comes to unicorns and startups, the value of these companies "is

77. *See* Zach Friedman, *These 197 Tech Companies Are the World's Most Valuable Unicorns*, FORBES (May 30, 2017, 10:32 AM), https://www.forbes.com/sites/zackfriedman/2017/05/30/tech-unicorns/#1a1b93181179 (explaining that in business, a unicorn is a private company that has a market valuation of at least $1 billion); *see also supra* text accompanying note 4.

78. *See* Jeff Schwartz, *Should Mutual Funds Invest in Startups? A Case Study of Fidelity Magellan Fund's Investments in Unicorns (and Other Startups) and the Regulatory Implications*, 95 N.C. L. REV. 1341, 1344 (2017).

79. Richard Teitelbaum, *Mutual Funds' Unicorn Problem*, INSTITUTIONAL INV. (Jan. 10, 2018), https://www.institutionalinvestor.com/article/b15yvz4ckw4f6h/mutual-funds-unicorn-problem (expressing concern that there may be a misunderstanding of what investments in private and startup companies could be worth).

80. *See* Sergey Chernenko et al., *Mutual Funds as Venture Capitalists? Evidence from Unicorns* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 23981, 2017), https://ssrn.com/abstract=2897254 (citing Yao Zeng, A Dynamic Theory of Mutual Fund Runs and Liquidity Management (Jan. 16, 2016) (unpublished paper), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2907718).

extremely sensitive to the contractual terms given to investors."[81] Mary Jo White, Chair of the SEC, even had some concern about unicorn valuations stating: "In the unicorn context, there is a worry that the tail may wag the horn, so to speak, on valuation disclosures. The concern is whether the prestige associated with reaching a sky high valuation fast drives companies to try to appear more valuable than they actually are."[82]

Although one of the benefits of investing in mutual funds is delegation to a professional manager, venture capital investments may raise some worries above and beyond traditional discomforts that come from someone else managing your own money.[83] The argument assessing the problems associated with internal valuation is best articulated by the following:

> Since startups are valued internally, these investments present risks regarding the accuracy of their valuations that are foreign to a portfolio consisting of the equity of publicly traded firms, where valuation simply equates to market prices. While other types of investments might also pose the risk of faulty valuations, here that risk is especially acute. Because startup valuation is particularly subjective, there is more room for error and bias. These unique risks make meaningful notice all the more important. For notice to be *meaningful*, funds must provide more than just a note that startups are present [within the asset portfolio]; unless investors are also informed of the associated risks, they cannot plausibly be viewed as informed.[84]

Nearly in the same vein, the investor-conscious objectives here seem to come face-to-face with fiduciary law. Because investment advisors are fiduciaries of the fund they manage, they are also fiduciaries of the fund's investors since they are "in a position to exploit [those] investors."[85]

81. Will Gornall & Ilya A. Strebulaev, *Squaring Venture Capital Valuations with Reality*, J. FIN. ECON. (2018) (forthcoming) (mentioning that availability of information about these companies is critical to investors, limited partners, and even employees).

82. Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Keynote Address at the SEC-Rock Center on Corporate Governance Silicon Valley Initiative (Mar. 31, 2016), https://www.sec.gov/news/speech/chair-white-silicon-valley-initiative-3-31-16.html.

83. *See* Schwartz, *supra* note 78, at 1354.

84. *Id.* at 1355–56 (footnote omitted).

85. Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1021 (2005).

One of the other problems that investors may experience with mutual fund investment in private firms is reduced liquidity, or a lack thereof.[86] Pursuant to the Investment Company Act, when an investor wants to redeem shares of the mutual fund, the mutual fund has up to seven days to comply with the request.[87] The argument then, proceeds as follows: "Since holdings in venture-stage firms are illiquid, and therefore unavailable to meet such requests, if a large percentage of a fund's portfolio is allocated to them, a fund might be unable to meet its obligations in times of stress."[88] Investors are not the only group who may be adversely affected by this rather illiquid market for private shares.[89] In an effort to mitigate this problem of mutual funds potentially having too many illiquid shares such that they will be unable to meet their redemption requirements, the SEC guidelines provide that no more than 15% of a fund's holdings may been in illiquid assets.[90] Despite the doom and gloom of this argument that mutual funds may be loading up on illiquid assets, at the end of 2016 a mere 3.7% of United States equity and allocation funds had capital in private companies.[91] This argument, while striking at first, may be overblown when considering that even if a particular fund invests in private firms, the percentage of assets in relation to the whole is miniscule at best.[92] As long as funds more or less stick to the SEC guidelines limiting the total percentage of assets that

86. Sarah Max, *Betting on Private Companies*, BARRON'S (Mar. 21, 2015), https://www.barrons.com/articles/more-mutual-funds-betting-on-private-companies-1426896483 ("There are, of course, problems, including a lack of liquidity.").

87. 15 U.S.C. § 80a-22(e) (2012) ("No registered investment company shall suspend the right of redemption, or postpone the date of payment or satisfaction upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security to the company or its agent designated for that purpose for redemption . . . .").

88. Schwartz, *supra* note 78, at 1365.

89. *See* Katie Benner, *Airbnb and Others Set Terms for Employees to Cash Out*, N.Y. TIMES (Aug. 10, 2016), https://www.nytimes.com/2016/08/12/technology/airbnb-and-others-set-terms-for-employees-to-cash-out.html (explaining that employees of technology startups are promised company shares under the guise of a "rich payday when the start-up eventually goes public or gets sold" but until then the shares cannot easily be traded).

90. Revisions of Guidelines to Form N-1A, 57 Fed. Reg. 9,828, 9,828 (Mar. 20, 1992) (to be codified at 17 C.F.R. pts. 239 & 274), https://www.sec.gov/rules/other/1992/33-6927.pdf (explaining that a 15% maximum "should satisfactorily assure that mutual funds will be able to make timely payment for redeemed shares.").

91. Bryan Borzykowski, *This is the Secret on How Mutual Funds Are Juicing Their Returns You Should Know About*, CNBC (May 17, 2017, 8:46 AM), https://www.cnbc.com/2017/05/17/mutual-funds-are-juicing-their-returns-by-investing-in-private-companies.html.

92. *See id.* (citing Fidelity as a brokerage of mutual funds that imposes a 10% limit on their managers with most funds, while in actuality only having 1–3% of their holdings in private companies).

may be illiquid, "there is little concern that [mutual funds] will be unable to meet their redemption commitments."[93]

A third problem that may plague mutual funds—and more importantly, those that invest in them—are the varying valuations that are prescribed to the private firms. Some attribute this variance to competing funds trying to assign a valuation to a "custom security with unique terms that may make it impossible to compare values across funds."[94] Additionally, some data may suggest that price dispersion—the difference in prices that funds assign securities for private firms—increases over time as some funds update prices based on reactions to news while others continue to value at out-of-date prices. However, the price dispersion decreases following a round of financing for the company because many funds then update their valuations to coincide with the deal price of the financing round.[95] While all mutual funds have internal valuation procedures[96] for these private firms that address the fact that the public market quotes are "not readily available or often not reliable,"[97] this does not seem particularly comforting for investors who may want more assurance than internal valuations. Moreover, embellished valuations create something of a misallocation of resources, not only within the marketplace for all mutual funds but also between the investors and those who manage the funds.[98] It is one thing to intentionally inflate prices when compensation is tied to those prices. But valuing securities that have no stable price is difficult work. Securities with easily accessible market prices are no issue, but valuations for private companies require mutual funds to make a "good faith determination of the amount for which the security could be sold in a current transaction."[99]

93. Schwartz, *supra* note 78, at 1365–66.

94. Francine McKenna, *Here's Why Mutual Fund Valuations of Private Companies Can Vary*, MARKETWATCH (Nov. 20, 2015, 12:25 PM), https://www.marketwatch.com/story/heres-why-mutual-fund-valuations-of-private-companies-can-vary-2015-11-20#false.

95. *See* Vikas Agarwal et al., Private Company Valuations by Mutual Funds 23 (Dec. 21, 2018) (unpublished article), https://ssrn.com/abstract=3066449.

96. Gregory M. Smith, *Mutual Fund Investments in Private Placements: An Overview*, INV. CO. INST. (Nov. 23, 2015), https://www.ici.org/viewpoints/view_15_valuation ("Because different funds can use different methods and inputs to value a private placement, it should not be surprising that different funds can derive different fair values for the same private placement.").

97. *See* McKenna, *supra* note 94.

98. Schwartz, *supra* note 78, at 1367–68 ("Buyers may have been wrongfully induced to invest in a certain fund based on the inflated values, which would have artificially exaggerated past returns. The inflated figures would also have led to inappropriately high compensation for the managers, whose pay is based on the NAV . . . .").

99. Smith, *supra* note 96.

Managers of mutual funds may also face pressures to over value these funds that invest in private companies. Although not explicitly mentioned, in a report that is some forty years-old, the SEC discusses competitive pressures for investment advisers by noting: "[o]ne disquieting result of these pressures has been to provide an incentive for investment managers to assume higher and higher levels of investment risk . . . a result that often is not apparent to the portfolios' sponsors or beneficial owners."[100] Traditional thought would assume that since managers of mutual funds earn extra compensation based on the amount of assets within the portfolio and not with incentive fees, the focus for these managers would be on growing the asset base.[101] But data may suggest otherwise.[102] If managers have an incentive to increase returns, there is a concern that the valuations of these private firms may be inflated. This may be problematic for investors due to the way they typically choose funds in which to invest.[103] There also might be an issue with fund managers smoothing returns. Some evidence suggests that managers might engineer higher valuations at the end of a particular year or quarter, negatively impacting the beginning of the next trading period.[104]

IV. INCREASED REGULATION MAY BE DETRIMENTAL

From a capital formation standpoint, increased regulation will only serve as a detriment to private companies, mutual funds, and ultimately, investors. "[E]fficiency, competition, and capital formation" are primary interests when the SEC is deciding on a proposed rule.[105] The SEC even

100. U.S. SEC. & EXCH. COMM'N, INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 92-64, pt. 8, at xiii (1st Sess. 1971).

101. Gregg S. Fischer et al., *Mutual Fund Outperformance and Growth*, 12 J. INV. MGMT. 8, 12 (2014).

102. *Id.* ("[A]n extra 10% of excess returns in one year by a midsize fixed income fund or a midsize or larger fund in any other style will on average lead to an extra 5–10% of excess asset growth in the subsequent year.").

103. Annette L. Nazareth, Comm'r, U.S. Sec. & Exch. Comm'n, Speech by SEC Commissioner: Remarks Before the Mutual Fund Directors Forum Seventh Annual Policy Conference (Apr. 12, 2007) (citing Prem C. Jain & Joanna Shuang Wu, *Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows*, 55 J. FIN. 937 (2000)) (explaining that investors focus too heavily on past performance of individual funds without taking into account the impact of fees).

104. *Investors Beware: Some Mutual Fund Managers Inflate Year-End Returns*, KNOWLEDGE@WHARTON (Jan. 20, 2000), http://knowledge.wharton.upenn.edu/article/investors-beware-some-mutual-fund-managers-inflate-year-end-returns/.

105. U.S. SEC. & EXCH. COMM'N, AUDIT NO. 347, RULEMAKING PROCESS (2002), https://www.sec.gov/oig/reportspubs/aboutoigaudit347finhtm.html.

has "capital formation" as part of its mission statement.[106] Historically, private firms have always had a choice to make in deciding whether to go public. Accepting mandatory disclosure costs allowed a company to gain the benefit of raising funds directly from the public.[107] Despite this seemingly significant incentive to listing on the public market, several studies have found that further increasing regulation will only serve to keep firms within the private sector as more companies are unwilling to incur rising disclosure costs.[108] These ongoing disclosure costs for public companies are considerably high.[109] The SEC posits that ongoing compliance costs can amount to around $1.5 million per year.[110]

Additionally, merely having an IPO can be expensive for private companies. Price Waterhouse Coopers issued a report detailing what it looks like to take a company public, revealing incremental costs (those costs incurred in preparing for the IPO) and offering costs (those costs directly attributable to the IPO process) are "in all cases . . . significant."[111] The underwriting fee, which the investment bank charges to actually take the company public, is "typically the largest IPO cost by far."[112]

A. Capital Formation Problems, Regulation, and Costs for Private Companies

Professor Christian Leuz, an accounting professor at Wharton, worries "that the cost of complying with SEC and other regulations may be too much for some companies to bear and that tough regulation could

106. U.S. SEC. & EXCH. COMM'N, STRATEGIC PLAN FISCAL YEARS 2014–2018, at 3 ("The mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.").

107. *See* Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 445 (2017).

108. *Id.* at 465 (citing Christian Leuz et al., *Why do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, 45 J. ACCT. & ECON. 181, 183 (2008)).

109. *See generally* David Nolte, *New Study Shows High Annual Costs of Being a Public Company*, BETWEEN NUMBERS (Jan. 6, 2012), http://betweenthenumbers.net/2012/01/new-study-shows-high-annual-costs-of-being-a-public-company/.

110. DAVID BURTON, THE HERITAGE FOUND., BACKGROUNDER NO. 2924, REDUCING THE BURDEN ON SMALL PUBLIC COMPANIES WOULD PROMOTE INNOVATION, JOB CREATION, AND ECONOMIC GROWTH 2 (June 20, 2014), https://www.heritage.org/jobs-and-labor/report/reducing-the-burden-small-public-companies-would-promote-innovation-job#_ftnref10 (quoting Crowdfunding, 78 Fed. Reg. 214 (proposed Nov. 5, 2013)).

111. PRICE WATERHOUSE COOPERS, CONSIDERING AN IPO TO FUEL YOUR COMPANY'S FUTURE? INSIGHT INTO THE COSTS OF GOING PUBLIC AND BEING PUBLIC 6 (Nov. 2017), https://www.pwc.com/us/en/deals/publications/assets/cost-of-an-ipo.pdf.

112. *Id.* at 13. This fee can range anywhere from 4–7% of the gross proceeds from the IPO. *Id.*

crowd out new ventures."[113] Recognizing the hesitation that many private firms expressed due to regulation and disclosure, Congress passed the JOBS Act in 2012 to try encouraging younger companies to go public.[114] Despite this intention, however, the JOBS Act only made it easier for private firms to stay private. By increasing the shareholder cap from 500 to 2000,[115] Congress has effectively allowed extremely large private companies to stay private yet still receive levels of capital that, until recently, were only thought attainable in the public market.[116] Moreover, the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 are two very big reasons why a private firm would want to stay private.[117] Not only does Sarbanes-Oxley impose accounting controls by requiring public companies to develop internal measures for financial reporting, along with requiring auditors to OK those internal measures,[118] Sarbanes-Oxley also created the Public Company Accounting Oversight Board to keep an eye on the audits that public companies are subject to under these securities laws.[119] Dodd-Frank is even more expansive than Sarbanes-Oxley and has two notable provisions. These include a "clawback" provision and a "say on pay" provision. If a public company conducted an accounting restatement due to misconduct, the CEO and CFO are required to return "any bonuses or stock-based compensations and any profits made from trading in company stock during the preceding three-year period" under the "clawback" provision.[120] As for the "say on pay" condition, public companies must, at least every three years, ask their shareholders whether they approve of the compensation levels for certain executives.[121]

Private companies have various means to raise capital. Although not subject to as strict regulation as public companies, private company capital formation is not without regulation. First, private placement agreements allow those looking to raise capital to sell securities to a

113. *Do High Regulatory Costs Force Public Firms to Go Private?*, KNOWLEDGE@WHARTON (Sept. 10, 2003), http://knowledge.wharton.upenn.edu/article/do-high-regulatory-costs-force-public-firms-to-go-private/.

114. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

115. 15 U.S.C. 78*l*(g) (2012).

116. *See* Usha Rodrigues, *The JOBS Act at Work*, CONGLOMERATE (Sept. 11, 2015), http://www.theconglomerate.org/jobs-act/.

117. Matthew J. O'Hara, *Staying Private Avoids SEC, but Not All Regulation*, AM. B. ASS'N (May 8, 2012), http://apps.americanbar.org/litigation/committees/businesstorts/articles/spring2012-0512-private-public-securities-regulation.html.

118. *Id.* (citing 15 U.S.C. § 7262 (2012)).

119. *Id.* (citing § 7211).

120. *Id.* (citing § 78j-4(b)(2)).

121. *Id.* (citing § 78n-1(a)–(b)).

small number of very select investors. Regulation D of the 1933 Securities Act grants a registration exemption for private placements allowing an issuer (in this case, the private company) to sell securities to accredited investors[122] (essentially, wealthy investors that are considered better able to protect themselves) using a private placement memorandum instead of a prospectus.[123] Another source of funding for private companies comes in the form of venture capital. Venture capital is typically provided in the very early stages of a company's life cycle and stems from wealthy investors, investment banks, and other financial institutions.[124] The tradeoff for those investing in the private company is that they get equity in the private company, meaning they get some say in company decisions.[125] After the JOBS Act was passed, venture capital funds could begin to advertise that they were selling securities, but only accredited investors can buy into them according to rule 506(c) of Regulation D.[126] The JOBS Act also paved the way for crowdfunding. This is a means for the general public to invest in early-stage private companies by pooling together resources.[127] Companies that are attempting to crowdfund must disclose a few key points among other things.[128]

While private companies are able to get financing via private channels, those channels are not free from regulation. Running out of

122. Rule 501 defines the accredited investor as a natural person with a net worth of $1,000,000 or income over $200,000 for each of the previous two years with a reasonable expectation of earning the same value for the current year. 17 C.F.R. § 230.501(a)(5), (6) (2019).

123. 17 C.F.R. § 230.501–.508; *see Private Placement*, INVESTOPEDIA, https://www.investopedia.com/terms/p/privateplacement.asp (last updated Apr. 1, 2019); *see also* Brian Hamilton, *The Best Way to Raise Money That No One Talks About*, INC. (June 29, 2012), https://www.inc.com/brian-hamilton/best-way-to-raise-money-that-no-one-talks-about.html.

124. *See generally* Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865 (1997).

125. *See Venture Capital*, INVESTOPEDIA, https://www.investopedia.com/terms/v/venturecapital.asp (last updated Mar. 22, 2019).

126. OFFICE OF INV'R EDUC. & ADVOCACY, U.S. SEC. & EXCH. COMM'N, SEC PUB. NO. 157 (9/13), ADVERTISING FOR UNREGISTERED SECURITIES OFFERINGS (2013).

127. 17 C.F.R. § 227.100 (2017).

128. Required disclosure for crowdfunding includes: a description of the business and business plan, material risk factors, the company's financial condition, directors, officers, and large shareholders, and the price of the securities or a method for determining the price. *See Crowdfunding and the JOBS Act: What Investors Should Know*, FINRA, http://www.finra.org/investors/alerts/crowdfunding-and-jobs-act-what-investors-should-know (last updated May 17, 2017).

funding can be a major reason why a private company fails to thrive.[129] While venture capital and private equity funding are available means to raise money, historically those options have not been reliable for many private firms.[130] For private companies looking to get off the ground, increased regulation would be particularly burdensome considering just some of the aforementioned regulation both public and private companies must go through. Given passage of the JOBS Act, the federal government seems to have recognized the important role that start-ups and private companies play in stimulating innovation.[131] In fact, "[e]ntrepreneurship has been the primary engine" for job growth within the United States for the last thirty years.[132]

B. *Increased Regulation May Cause Problems for Private Firms via Mutual Funds*

It is already difficult enough for private companies to establish themselves within a market. Funding can be tight and investors are unable to take advantage of the potential for higher returns because generally only accredited investors may invest in such speculative endeavors. However, mutual funds are able to invest in private firms with the "aggregate valuation of mutual funds' investments in private firms increas[ing] from $16 million in 1995 to over $8 billion in 2015."[133] Moreover, for those companies that went public in 2016 that received venture-backed capital, 39% received some form of mutual fund financing prior to going public.[134] Effectively, private companies are able to take advantage of yet another source of funding. This allows the private firm

129. David Skok, *5 Reasons Startups Fail*, FORENTREPRENEURS, https://www.forentrepreneurs.com/why-startups-fail/ (last visited Feb. 25, 2018).

130. Less than 1% of U.S. companies are normally able to take advantage of venture capital funds. Michael Lewis, *6 Things You Need to Know About Raising Capital for a Small Business*, HUFFINGTON POST, https://www.huffingtonpost.com/michael-lewis/6-things-you-need-to-know_b_3484069.html (last updated Aug. 23, 2013),

131. Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3402, 3402 n.57 (2013) ("Entrepreneurship is a primary contributor to job creation and sustainable economic growth, and policies affecting innovation and startup financing have wide ramifications." (quoting Steven J. Markovich, *U.S. Entrepreneurship and Venture Capital*, COUNCIL ON FOREIGN REL. (June 4, 2012), http://www.cfr.org/united-states/us-entrepreneurship-venture-capital/p28433)).

132. Markovich, *supra* note 131 (citing JOHN HALTIWANGER ET AL., U.S. CENSUS BUREAU, BUSINESS DYNAMICS STATISTICS BRIEFING: JOBS CREATED FROM BUSINESS STARTUPS IN THE UNITED STATES (2008), https://www.census.gov/ces/pdf/BDS_StatBrief1_Jobs_Created.pdf).

133. *See* Sungjoung Kwon et al., Mutual Fund Investments in Private Firms 1 (Mar. 14, 2019) (unpublished paper), https://ssrn.com/abstract=2941203.

134. *Id.*

to stay private for longer, minimizing disclosure costs along the way. Andrew Boyd, who is responsible for Fidelity Investments global equity capital markets team, says that the increasing amount of investments in private firms is due to "a change in the marketplace, not a change in what we're doing."[135] In addition to injecting capital into the business, having mutual fund involvement seems to serve as something akin to a litmus test for measuring company health.[136]

There has been a gradual increase from the time a company receives its first round of venture funding and the time it goes public, suggesting that private firms today are more developed and arguably less risky than in years past.[137] For investment firms like Fidelity that do invest in private companies, there is still work to be done after the investment has been made.[138] Typically, investment firms keep a very low percentage of assets relative to their complete holdings in private companies.[139] Mutual funds offering yet another means for a private company to secure capital helps drive the cost of that capital down overall. Essentially, then, this is "economics 101—more supply lowers the price of the capital needed."[140] Permitting everyday investors to invest in private companies via mutual funds also allows the company to stay private longer, reducing costs and allowing profits thus to be reinvested into the business in an effort to improve long-term growth.[141] With venture capital funding, it is common

135. Max, *supra* note 86.

136. Steve Schaefer, *Getting into the Unicorn Boom: 10 Mutual Funds with Stakes in Pre-IPO Tech Stars*, FORBES (Oct. 14, 2015, 3:25 PM), https://www.forbes.com/sites/steveschaefer/2015/10/14/unicorns-funds-fidelity-trowe-uber-dropbox/#1fd451582a92 (surmising that a mutual fund's investment into the private forum functions something like a "seal of approval").

137. *See* Max, *supra* note 86 ("In 2000, the median time between a first round of venture financing and an IPO was 3.1 years, according to the National Venture Capital Association. In 2013, it was 7.4 years.").

138. *Mutual Funds are Placing Big Bets on Privately Held Companies to Get a Head Start on Possible IPOs*, BUS. INSIDER (June 4, 2015), http://www.businessinsider.com/r-mutual-funds-chase-head-start-on-hit-ipos-with-pre-public-investing-2015-6). Fidelity often holds regular meetings with the firms they invest in to determine the company's ability to provide accurate quarterly estimates and handle tough scrutiny from incredulous fund managers. *Id.*

139. *See id.* (explaining that Fidelity typically has less than 1% of its assets in private companies); *see also* Conrad De Aenlle, *Mutual Funds Buy Hot Stocks Like Snap Ahead of I.P.O.s*, N.Y. TIMES (Apr. 14, 2017), https://www.nytimes.com/2017/04/14/business/mutfund/snapchat-ipo.html ("The practice of purchasing privately traded equities is fairly common among large fund companies, albeit usually in small amounts relative to their assets.").

140. Simon Constable, *More Mutual Funds are Pumping Money into Small Firms*, WALL ST. J. (Apr. 30, 2017, 10:04 PM), https://www.wsj.com/articles/more-mutual-funds-are-pumping-money-into-small-firms-1493604240.

141. *Id.*

for the venture capitalist to exit and take profits once the company goes public. With mutual fund investment, however, funds are able to prove longer-term capital to the company even post-IPO.[142] Increased regulation on how mutual funds invest in private companies will only serve to adversely affect those companies when they already face capital formation problems. Mutual funds are required to publicly disclose their holdings every quarter, and they must identify each security owned by name, the total number of shares owned for that security, and note each security that is not registered with the SEC.[143] Even if the federal government wanted to increase regulation to further limit how mutual funds can invest in private companies, mutual funds still need to keep investors happy. Because of this, mutual funds will simply pass the increased regulatory costs onto the private companies indirectly, similar to what mutual funds do for retail investors.[144] Maintaining the status quo from a regulatory perspective provides not only private companies the benefit of increased funding, it also benefits the mutual funds themselves, which in turn benefits the individual investor. Investment firms are not just finding any private company and investing in them hoping to hit a home run. They take their time with investing in such speculative investments and frequently pass up opportunities in favor of private firms that are more late-stage.[145]

C. Investors Ultimately Benefit from the Current Regulatory Scheme

Granting private company access to retail investors via investment in mutual funds under the current regulatory scheme offers investors a bite at the growth apple that they would not otherwise have. When securities law offers too much protection for investors, those investors are effectively placed in a regulation straitjacket.[146] The problem here with the current securities laws is that the focus has been entirely on the seller and not the opportunity lost for the buyer.[147] There is no question that

142. *Id.*
143. Smith, *supra* note 96.
144. Ty A. Bernicke, *The Real Cost of Owning a Mutual Fund*, FORBES (Apr. 4, 2011, 12:01 PM), https://www.forbes.com/2011/04/04/real-cost-mutual-fund-taxes-fees-retirement-bernicke.html#61f23f163244 ("[H]idden costs have infiltrated the mutual fund industry and are being paid by many unsuspecting investors.").
145. Fidelity tends to focus on late-stage private companies that allow investors to benefit from early growth without jumping at every opportunity, even though there is no shortage of said opportunities. *See* Schaefer, *supra* note 136.
146. Rodrigues, *supra* note 131, at 3417.
147. *Id.* at 3425–26. ("[S]ecurities law doctrine has always focused on the firm—the seller—rather than the buyer (except in the context of investor protection). . . . The

private markets are risky. No one is arguing that point.[148] But, the ace in the hole for retail investors is diversification.[149] Investors can, in essence, have their cake and eat it too by investing in mutual funds that allow them to indirectly access the private market. They acquire the benefit of the potential for increased returns, and diversification affords them the opportunity to hedge against the risk that attaches to such restricted investments.[150] Investors already believe they can beat the market by buying low and selling high instead of buying with a long-term view and selling shares slowly and incrementally. Notwithstanding how mistaken this view might be, some suggest that it is just human behavior driven by an eternal optimism.[151] If this inevitability of investor behavior is to be accepted, securities law needs to find another way to protect investors (if that really is the goal) that is not just shutting out investors from potentially enormous gains in their portfolio.[152] Indirect private company investment through a mutual fund accomplishes both goals. It exposes retail investors to potentially higher returns while at the same time providing diversification since mutual funds typically limit their involvement in the private market. "Crowding out" the investor by increasing regulation for fear that the investor will be taken advantage of is not the answer.[153] Retail investors who would like to invest in private companies also benefit from a cost perspective by using mutual funds rather than some other investment vehicle. Typically, mutual funds require substantially reduced investment minimums compared to

classic justifications for mandatory federal securities regulation turn on the desirability of requiring firms to disseminate knowledge . . . .").

148. Indeed, "[a]dding private companies to portfolios should never replace investments in U.S. and international large-cap stocks, but instead should be added as non-correlated assets that do not track the performance of major stock indices." Douglas Fink, Opinion, *How to Invest in the Trump Era: Buy Shares of Private Companies*, MARKETWATCH (Jan. 31, 2017, 8:28 AM), https://www.marketwatch.com/story/how-to-invest-in-the-trump-era-buy-shares-of-private-companies-2017-01-31.

149. Houman B. Shadab, *Fending for Themselves: Creating a U.S. Hedge Fund Market for Retail Investors*, 11 N.Y.U. J. LEGIS. & PUB. POL'Y 251, 267 (2008) ("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.).").

150. Janet Kiholm Smith et al., *The SEC's "Fair Value" Standard for Mutual Fund Investment in Restricted Shares and Other Illiquid Securities*, 6 FORDHAM J. CORP. & FIN. L. 421, 471 (2001).

151. Lynn A. Stout, *Uncertainty, Dangerous Optimism, and Speculation: An Inquiry into Some Limits of Democratic Governance*, 97 CORNELL L. REV. 1177, 1183–85 (2012).

152. Rodrigues, *supra* note 131, at 3429.

153. Zachary J. Gubler, *Public Choice Theory and the Private Securities Market*, 91 N.C. L. REV. 745, 800 (2013) (arguing that crowding out the investor leaves early-stage growth companies out of reach, thus leaving the individual investor with an inability to optimize their portfolio).

venture capital or private equity funds and the operating expenses are also comparably cheaper.[154] Giving investors the keys to the kingdom via mutual fund access also takes some of the pressure off the crowdfunding initiative. While crowdfunding might be a great avenue for private companies to raise capital, it does not do much for the average retail investor. Allowing indirect private investment via mutual funds fills that gap for the little guy.[155] There seems to be rather high demand for risky investments among retail investors,[156] and increased regulation will only serve to further widen the divide between those sophisticated investors who have access to some of the most profitable investments, and the ordinary retail investor for whom the SEC claims to ensure protection.[157]

V. CONCLUSION

Private companies and investors benefit too greatly under the current regulatory regime to burden them with increased regulation. The mutual fund industry has continued to grow larger and larger over the years as investors pour more capital into them because of the easy diversification they provide with a minimal amount of effort on the part of the investor. Further, many investors place money that will be saved for retirement in those funds hoping that it will grow over time. These same mutual funds are already extensively regulated, and private companies are private because they fear being saddled with disclosure costs and investor interference.

Allowing investors to participate in this private market is beneficial for the private firms, the mutual funds themselves, and the investors. Private companies gain increased access to capital, and, effectively, an established big brother watching over them as they hopefully progress towards an IPO. Mutual funds benefit from the increased returns investing in such high growth companies provides. While investors should not keep a majority of money in a fund that invests in private companies, they can hedge against the risk associated with the private companies by keeping their portfolios diversified.

Moreover, the fears that mutual funds will invest all of their clients' money in risky private investments is likely not the case considering they

154. Aaron Levitt, *Mutual Funds and Pre-IPO Companies*, MUTUALFUNDS.COM (Oct. 9, 2014), http://mutualfunds.com/actively-managed-funds/mutual-funds-pre-ipo-companies/.

155. Rodrigues, *supra* note 131, at 3433.

156. *See generally* Steven M. Davidoff, *Black Market Capital*, 2008 COLUM. BUS. L. REV. 172 (2008).

157. *See* Gubler, *supra* note 153, at 800; *see also* Rodrigues, *supra* note 131, at 3414 (suggesting that the current securities laws create a distinctively uneven playing field for ordinary investors under the guise of safety from selective disclosure).

keep a fraction of their portfolio in private companies and they tend to stick to late-stage, proven private companies. Given these considerations, securities law is funny in a sense. The question remains: "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?"[158]

158. Rodrigues, *supra* note 131, at 3434.