Secondary Markets in Private Equity
and the Future of U.S. Capital Markets

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TABLE OF CONTENTS

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I. INTRODUCTION

Since 1980, the private equity market consistently has been the fastest growing of the capital markets, "by an order of magnitude over other markets such as the public equity and bond markets and the market for private placement debt."[1] As it has grown, the private equity industry has been transformed, from a small group of unknown deal shops, to the feared "two-tier, bust-up junk-bond" raiders of the 1980s, to the "money of innovation" of the late 1990s and, finally, to the well funded, institutionalized investors of today. Traditionally, private equity enjoyed a symbiotic relationship with the public equity market. Venture capital (VC) funds provided seed money and advice to firms too small or too risky to raise capital from public investors, while leveraged buyout (LBO) funds took flagging, mature firms private in order to reform them. Both species of private equity looked to the public equity market, particularly the initial public offering (IPO) market, as a means of realizing attractive returns on their investments.

Over the last decade, and particularly in recent years, both private equity and the U.S. public equity market have been transformed. Since the beginning of 2004, private equity funds have experienced an enormous influx of capital, and put their money to work taking companies private. In the past three years, private equity funds have raised more than $756 billion of capital globally, $345 billion of that in the United States.[2] Over the same period, LBOs have risen to account for 18% of global mergers and acquisitions (M&A), and nearly 25% of U.S. M&A. During the same period, the U.S. public equity market, has suffered under the weight of an increased regulatory and litigation burden, raising concerns about its global competitiveness.[3]

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[1] George W. Fenn, et al., THE ECONOMICS OF THE PRIVATE EQUITY MARKET 1 (1995).
[2] Source for global figure: Thomson Financial (see Figure 2). Source for U.S. figure: Private Equity Analyst Plus.
[3] INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (Nov. 30, 2006); see also, McKinsey & Co., SUSTAINING NEW YORK'S AND THE U.S.'S GLOBAL FINANCIAL SERVICES LEADERSHIP (Jan. 2007), and U.S.

The U.S. IPO market is less welcoming to VC-backed portfolio companies, while LBO-sponsored firms must stay private longer before returning to public ownership. At the same time, going public in the U.S. has become much less attractive to foreign and domestic companies. Indeed, they have begun to show an unprecedented "preference for U.S. private markets over public markets."[4]

This paper frames the development of secondary markets in private equity as a response both to the traditional illiquidity of private equity and to the current state of public capital markets, particularly the U.S. public equity market. It also considers how the emergence and expansion of these secondary markets in private equity in turn may transform the relationship between private and public markets. The paper proceeds as follows. Part II describes the structure and history of private equity investing, with attention to the relationship between private equity and the IPO market. Part III unpacks the functional elements of three distinct secondary markets in private equity: private sales of portfolio companies (acquisition exits and secondary buyouts), private sales of "secondaries" and their purchase by secondary funds, and public sales of common units in publicly traded private equity vehicles. Part IV discusses the current rules and regulations governing these secondary markets. Part V considers these developments and the investor protection and competitiveness issues thereby raised. It makes a few, simple policy proposals, and concludes.

II. STRUCTURAL ILLIQUIDITY OF PRIVATE EQUITY

The vast majority of investments in private equity flow through private equity funds, limited partnerships managed by investment professionals. Investors' stakes in these limited partnerships are highly illiquid, as are the partnerships' stakes in the companies in which they

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Chamber of Commerce, COMMISSION ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY: REPORT AND RECOMMENDATIONS (March 2007).

[4] INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION, supra note 3, 4.

invest. Investors must commit their capital to a fund for ten years or more, during which time they have little control over its deployment and few opportunities for early exit. Moreover, private equity funds must commit their pools of capital to portfolio companies for a number of years before those investments can be exited profitably. This section describes the history of venture capital and private equity, the illiquidity of private equity investments, and the traditional relationship of private equity to public capital markets.

a. Overview of Venture Capital and Private Equity

The private equity industry as we know it emerged during the 1980s.[5] Until the late 1970s, most private equity investments were direct investments undertaken by "angels" (individual investors), corporations, and financial institutions.[6] During this period, most high-risk young firms in need of "venture capital" raised money through publicly traded closed-end funds or Small Business Investment Companies (SBICs) chartered by the federal government.[7] The closed-end funds suffered from the tension between the immediate price transparency of publicly traded securities and the long investment horizon required to realize returns on private equity investments, often trading at substantial discounts to net asset value.[8] SBICs also were imperfect vehicles for private equity investing. They attracted mainly individual rather than institutional investors, were extensively regulated, and "did not attract managers of the highest caliber."[9] Most SBICs had collapsed by the late 1970s.[10]

Regulatory and tax changes of the late 1970s and early 1980s sparked greatly increased investment in private equity. The most important regulatory change was the Labor Department's

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[5] Fenn, supra note 1, 15.
[6] Fenn, supra note 1, 26.
[7] Paul A. Gompers & Josh Lerner, *The Venture Capital Revolution*, 15 J. OF ECON. PERSPECTIVES 2, 145, 147 (2001).
[8] Id. at 146-147.
[9] Fenn, supra note 1, 8.
[10] Id.

1979 ruling that the "prudent man" provision of the Employee Retirement Income Security Act did not preclude pension funds from investing in venture capital and private equity funds.[11] This decision enabled pension funds to make greatly increased commitments to venture capital funds.[12] In 1980, the Labor Department's decided to exempt private equity funds from "plan asset" regulations requiring them to register as advisers under the Investment Advisers Act of 1940.[13] The same year, Congress passed the Small Business Investment Incentive Act of 1980, which gave private equity firms the option to register as "business development companies" (BDCs) under the Investment Company Act of 1940 ("1940 Act"), exempting them from registration as investment advisers if they had 14 or fewer "clients" (funds under management).[14] In 1981, Congress cut the capital gains tax rate to 20 percent, which encouraged managers to become entrepreneurs and investment bankers to form private equity funds.[15]

In the wake of this regulatory liberalization, private equity investing took off. Between 1980 and 1999, the U.S. private equity market grew from about $5 billion to more than $175 billion in investment.[16] As the industry developed, private equity funds evolved into two species: venture capital (VC) and leveraged buyout (LBO) funds. VC funds provide financing to firms that cannot access the public equity markets or secure traditional debt financing.[17] The typical VC-backed firms are "start-up companies that lack substantial tangible assets, expect several years of negative earnings, and [face …] uncertain prospects," but demonstrate a

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[11] Id. at 10-11.
[12] Paul A Gompers & Josh Lerner, *What Drives Venture Capital Fundraising?* BROOKINGS PAPERS ON ECONOMIC ACTIVITY 149, 166 (1998).
[13] Fenn, supra note 1, 11.
[14] Id.
[15] Gompers & Lerner, supra note 12, 167.
[16] Raghuram G. Rajan & Luigi Zingales, SAVING CAPITALISM FROM THE CAPITALISTS: UNLEASHING THE POWER OF FINANCIAL MARKETS TO CREATE WEALTH AND SPREAD OPPORTUNITY (2d ed., 2004) 71. To give a sense of scale, in 1999 U.S. private equity investment was only $9 billion less than the total investment of Italy, public and private.
[17] Gompers & Lerner, supra note 7, 145.

potential for great rewards.[18] LBO funds occupy a different place in the corporate lifecycle. They are created with the goal of acquiring public corporations or divisions thereof and taking them private, and generally fund their acquisitions with a majority of borrowed funds.[19]

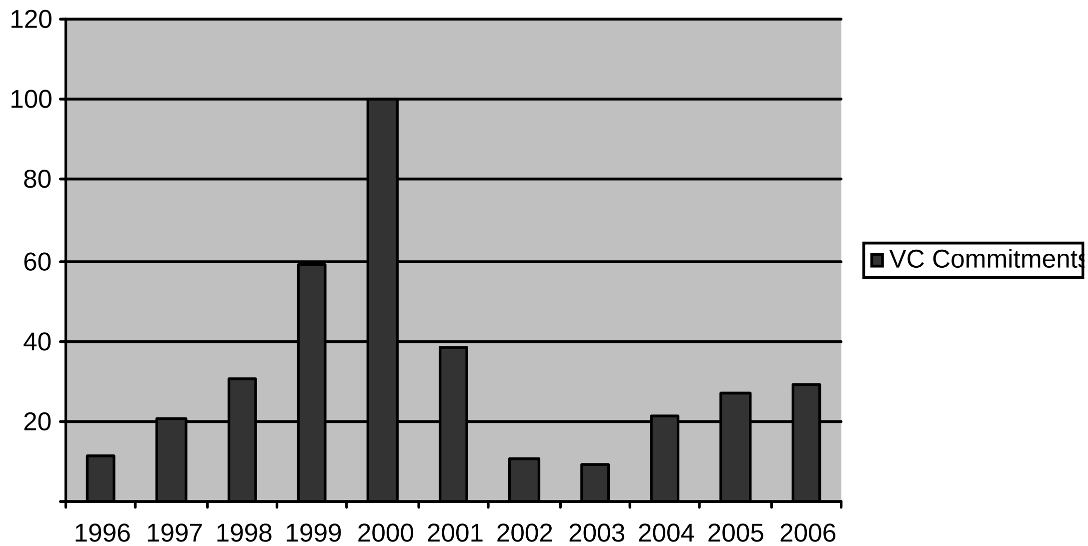
Each species of fund has had its moment in the sun. During the 1980s, LBO activity—and, famously, hostile LBO activity—reached unprecedented levels.[20] Many explanations have been offered for this great exodus from the public capital markets: the rise of the institutional investor (Donaldson), a "return to specialization" (Shleifer and Vishny), and the "eclipse of the public corporation" (Jensen).[21] In the end, the LBO explosion probably was caused by a combination of these factors.[22] Whatever the cause, LBO activity subsided subsequently to such an extent that by 2001 two students of the phenomenon announced, "the privatization movement has stopped."[23]

VC fundraising and profit-making peaked in 2000, with the internet bubble. In 2000, investors committed more than $100 billion to U.S. VC funds, roughly one-third of the total amount committed to private equity investment worldwide. In 1999 and 2000, there were more than 450 venture-backed initial public offerings (IPOs), which together raised nearly $40 billion from public investors (see Figure 6, infra p. 16). When U.S. public equity markets crashed, so did VC fund commitments and venture-backed IPOs. In 2001 and 2002, there were fewer than

[18] Paul Gompers & Josh Lerner, *Money Chasing Deals? The Impact of Fund Inflows on Private Equity Valuations*, 55 J. OF FIN. ECONOMICS 281, 284 (2000).
[19] Jack S. Levin, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS ¶ 105.4 (2005).
[20] Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. OF ECON. PERSPECTIVES, 121, 125-126 (Spring 2001).
[21] Gordon Donaldson, CORPORATE RESTRUCTURING (1994); Andrei Shleifer & Robert W. Vishny, *The Takeover Wave of the 1980s*, 249 SCIENCE, 745-749 (Aug. 17, 1990); and, Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. R. (September-October 1989) (Revised 1997) 22, available at http://papers.ssrn.com/abstract=146149. Cited in Holmstrom & Kaplan, supra note 20, 129-131.
[22] Holmstrom & Kaplan, supra note 20, 132.
[23] Id.

45 venture-backed IPOs, which together raised less than $4 billion. Commitments to U.S. VC funds reached a low of $9.2 billion in 2003, and have yet to regain their 1998 levels (Figure 1).

Figure 1: U.S. VC Fund Commitments, 1996-20

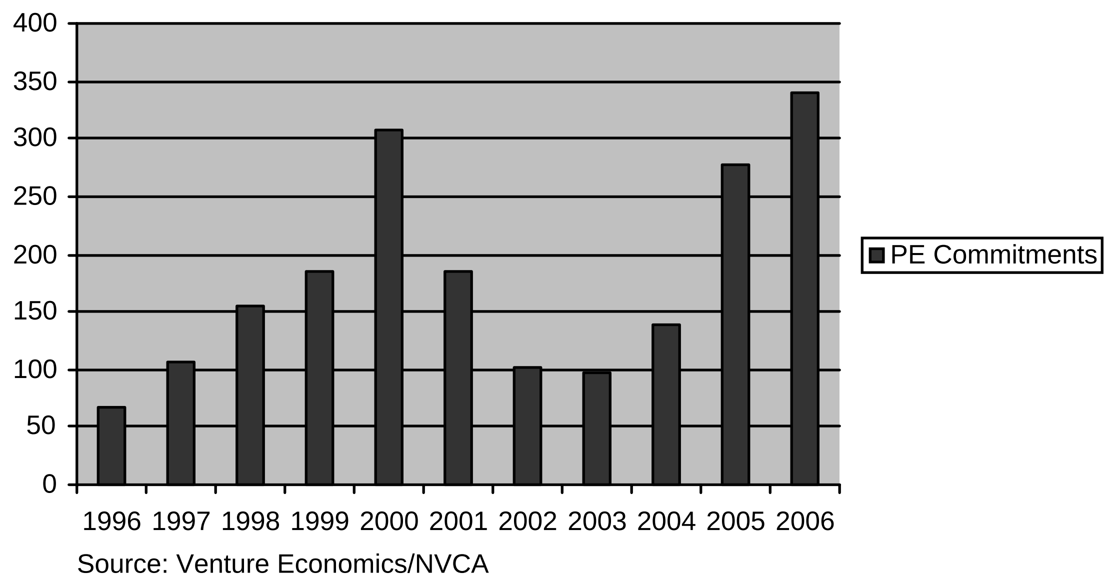


Source: Venture Economics/NVC

As U.S. VC funds have begun a slow recovery, global private equity investing has boomed, led mainly by LBO funds. In 2006, investors worldwide committed $339.5 billion to private equity funds (Figure 2). Spurred on by a global liquidity glut and the availability of inexpensive debt financing, these funds have put their money to work. In 2006, LBO funds accounted for more than $750 billion of announced deal volume worldwide, 18% of the global total (Figure 3). In the U.S., nearly one-quarter of mergers and acquisitions announced in 2006 were LBOs (Figure 4). Nine of the ten largest private equity deals have occurred since 2004, including the largest, Blackstone Group's $38.9 billion buyout of Equity Office Properties

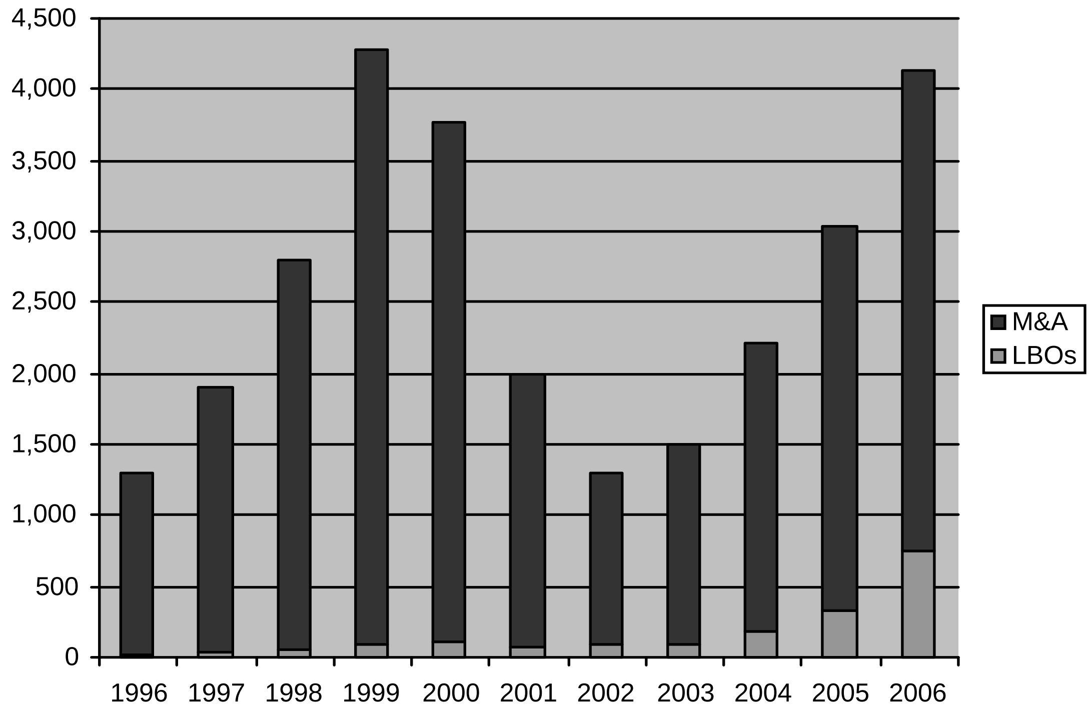
Trust.[24] The return of the privatization movement makes it imperative to understand the relationship between private equity and public capital markets.

Figure 2: Global PE Fund Commitments, 1996-2006



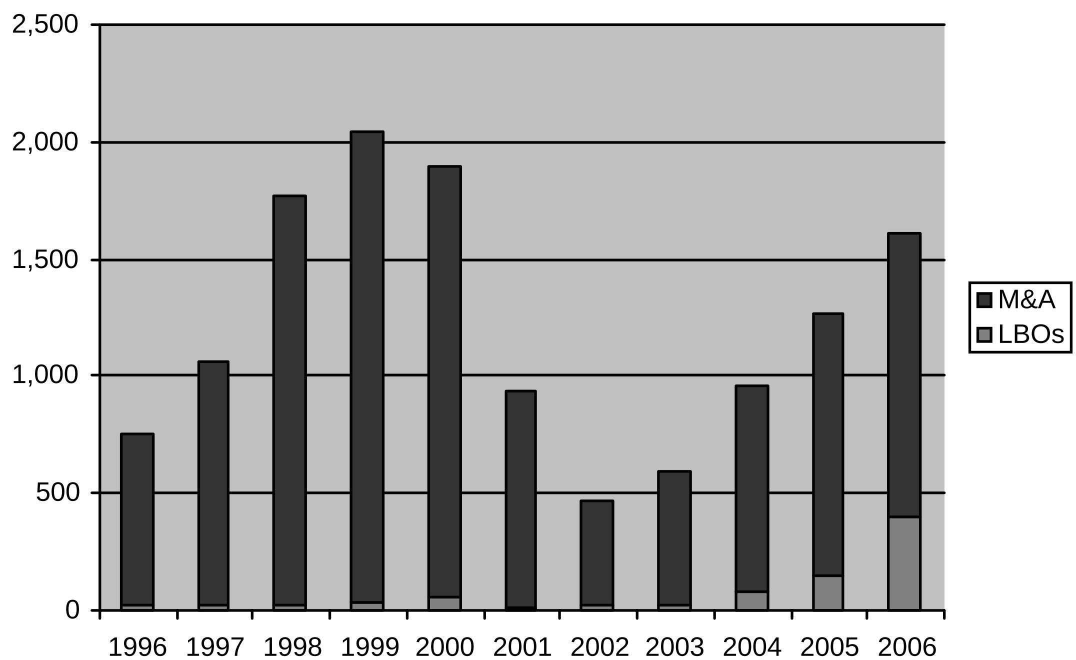
[24] *Top Ten Deals: The Biggest Private Equity Deals of All Time*, FORTUNE (Feb. 23, 2007) available at http://money.cnn.com/2007/02/16/magazines/fortune/top10.fortune/index.htm.

Figure 3: Global M&A, 1996-2006



Source: Thomson Financial

Figure 4: U.S. M&A, 1996-2006



Source: Thomson Financial

b. Illiquidity of Private Equity Investments

Almost all contemporary private equity funds are structured as private limited partnerships.[25] The limited partnership form is attractive to investors because they receive both limited liability and flow-through taxation (no entity-level tax on the fund).[26] Tax-exempt organizations such as pension funds and university endowments thus might pay no taxes at all.[27] However, the downside to forming a limited partnership—as opposed to a BDC or SBIC—is the highly illiquid nature of investors' interests in the fund. Federal securities regulation—or, more precisely, private equity funds' avoidance thereof—restricts the transferability of passive investors' limited partnership interests. Provisions of the limited partnership agreement usually also limit resale. Private equity investors have been willing to accept illiquidity and its associated risks in exchange for returns that are tax-advantaged, uncorrelated with other investments, or simply better in absolute terms.

Figure 5 represents a small venture capital (VC) fund structured as a limited partnership. Figure 5 is simplified in three respects. First, it does not take account of the equity stakes held by the managers and employees of the portfolio companies (PCs). Second, if it depicted an LBO fund, each PC also would have numerous creditors. Third, a single private equity general partnership will manage a number of private equity funds, each with its own investors and investments. Michael Jensen has dubbed this organization of general partners, investors, portfolio company managers, and creditors an "LBO Association."[28]

The formation of a private equity fund limited partnership proceeds as follows. Individual general partners (GPs) establish a management firm, in the form of a limited

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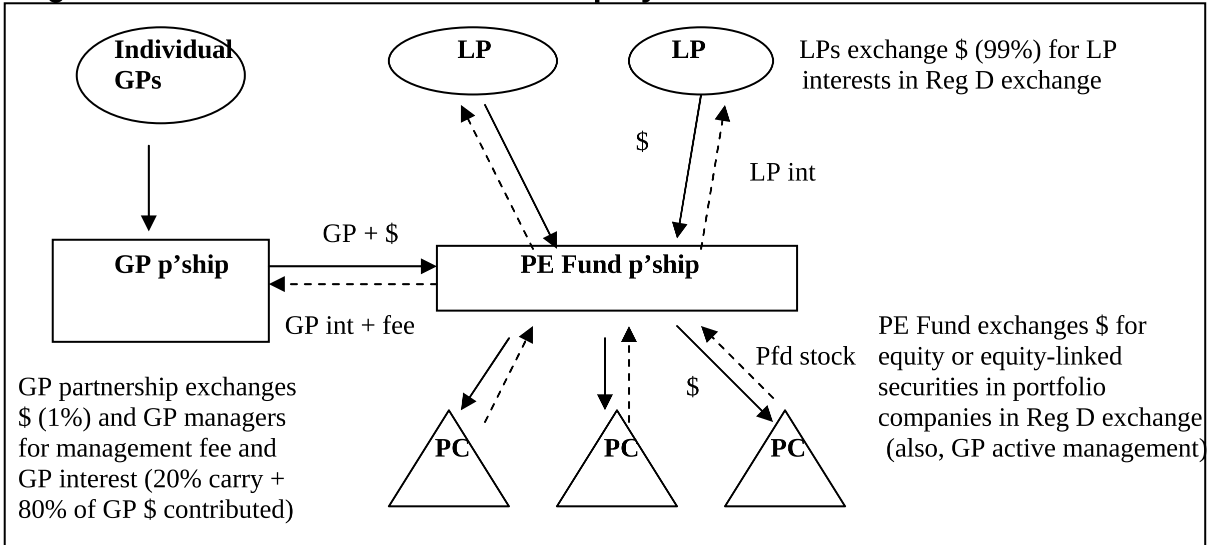
[25] Fenn, supra note 1, 26.
[26] Levin, supra note 19, ¶¶ 302.1 & 302.2.
[27] These organizations now play a major role in private equity investing. Gompers & Lerner, supra note 7, 152.
[28] Jensen, supra note 21, 14.

Figure 5: The Structure of a Private Equity Fund



Source: Jack S. Levin, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS, Chapter 10 (2005).

partnership. The GP firm contributes a small part of the PE fund's capital (usually 1%) and chooses one or more of its GPs to select, structure, and oversee the PE fund's investments. The GP firm raises the bulk of the capital for a PE fund (99%) from limited partners (LPs). When a fund is raised, LPs commit to invest a certain amount of capital in exchange for limited partnership interests in the PE fund. LPs also agree to pay the GP firm an annual management fee (usually 2% of capital under management) and to compensate the GP firm for its intermediation with a "carried interest" in returns from the PE fund (usually 20%).

LPs investments in PE funds are highly illiquid. Most PE funds have a 10-year life.[29] Generally, committed capital is "drawn down" from LPs and invested in portfolio companies during the first 5 years of the fund's life, and investments are sold within 3 to 7 years of the original investment in the portfolio company.[30] According to Alexander Ljungqvist and Matthew Richardson, who examined the private equity cash flows of a large U.S. institutional investor in

[29] Levin, supra note 19, ¶ 103.
[30] Id.

private equity, the average (median) fund in the group invested 80 percent or more of its commitments within 3.69 (4) years.[31] As a fund exits its investments, LPs receive distributions of cash or securities. LPs must be patient: Ljungqvist and Richardson found that it takes almost 7 years for the average PE fund to return all of the LPs' committed capital and begin to generate positive returns.[32] After 10 years, the fund must disburse its remaining assets to its limited partners (often, however, there is a wind-up period of as much as 3 years).[33]

Federal securities regulation prohibits investors from publicly offering and selling their limited partnership interests in private equity funds. In order to avoid the cost, time, and disclosure associated with registering a public offering of securities under the Securities Act of 1933 ("1933 Act")[34] and maintaining a public company under the Securities Exchange Act of 1934 ("1934 Act"),[35] GPs prefer to sell limited partnership interests in a PE fund to "accredited investors"—individuals with a net worth of at least $1 million or an annual income of at least $200,000, and entities with assets of $5 million or more—in private placements.[36] Typically, these private placements are undertaken pursuant to the Rule 506 safe harbor of Regulation D, which places no limit on the amount of funds that may be raised.[37] Limited partnership interests are "restricted securities" that may not be resold publicly unless the holding period and volume requirements of Rule 144 are met.[38] These restrictions on transferability of limited partnership interests are discussed in detail infra, at IV.b.ii.

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[31] Alexander Ljungqvist & Matthew Richardson, *The Cash Flow, Return and Risk Characteristics of Private Equity*, NATIONAL BUREAU OF ECONOMIC RESEARCH Working Paper No. 9454, 11 (2003).
[32] Id. at 13.
[33] Levin, supra note 19, ¶ 103.
[34] 15 U.S.CA. §77a et seq.
[35] 15 U.S.C.A. § 78a et seq.
[36] 17 C.F.R. § 230.501(a)(5)-(8) (1989). See generally, Levin, supra note 19, Chapter10; see also, Steven E. Hurdle, Jr., *A Proposed Legislative Solution for Private Equity Fund Disclosures*, 8-11 (Nov. 2004) (unpublished manuscript, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625441).
[37] 17 C.F.R. § 230.506 (1989).
[38] 17 C.F.R. § 230.144(d) & (e) (1989).

Contractual provisions also limit the liquidity of LPs' investments. GPs restrict resales of limited partnership interests by contract for two reasons. First, GPs typically seek to avoid registering their PE funds under the 1940 Act.[39] In order to do so, GPs must either keep fund membership at or below 100 investors, no more than 35 of whom may be unaccredited investors,[40] or allow only "qualified persons"—individuals with investment assets of at least $5 million, or entities with investment assets of at least $25 million—to invest in the fund.[41] Thus, contracts for the sale of limited partnership interests will stipulate that an LP's resale must not cause the fund to lose its exemption from registration under the 1940 Act.[42] Second, GPs prefer to restrict early exits for business reasons, among them the wish to avoid the reputational costs associated with LPs exiting early, and the desire to keep "unwanted" investors out of their funds. PE fund agreements typically impose multiple conditions upon resale, including the requirement that the GP approve a proposed LP-interest sale.[43] In the words of one industry observer, "general partners have the final word on whether the deals get done."[44]

Finally, the nature of limited partnership interests itself limits their transferability. First, investors in private equity do not immediately contribute all committed capital to the fund. Indeed, in the typical venture capital fund, limited partners initially contribute only 20-25% of the committed amount.[45] This gives an investor a degree of leverage over the general partners in charge of the fund; however, it also means that limited partnership interests lack the fungibility associated with the common stock of corporations. Furthermore, because general partners often issue capital calls at short notice, the decision to purchase a limited partnership interest will

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[39] See generally, Levin, supra note 19, Chapter10; see also, Hurdle, supra note 34, 8-11.
[40] 15 U.S.C. 80a-3(c)(1) (2004).
[41] 15 U.S.C. 80a-3(c)(7) (2004).
[42] Levin, supra note 19, ¶ 1012.3.
[43] Id. at ¶ 1012.2.
[44] Matthew Sheahan, *GPs Hold the Key*, VENTURE CAP. J., March 1, 2004.
[45] Jay S. Rand & Allen L. Weingarten, *When Limited Partners Default*, J. OF PRIVATE EQUITY 31, 31 (Spring 2002).

expose the buyer to liquidity risk.[46] Second, investors in a particular private equity fund will always have greater information about the fund's performance and prospects than an outside investor. Thus, transfer of limited partnership interests creates a classic "lemons" problem.[47] The risk of adverse selection and the requirement of due diligence will lower the price of any limited partnership interest ultimately offered for sale.

c. Liquidity through Exit: Private Equity and Public Capital Markets

Like an LP's interest in a PE fund, the investments of VC and LBO funds in their PCs are highly illiquid. For VC and LBO funds alike, the preferred path to liquidity—the preferred "exit option"—has been to take a PC public in an initial public offering (IPO). For VCs in particular, IPOs are "the pinnacle of a successful investment."[48] Since 2001, however, the IPO "window" has barely cracked open for U.S. VC-backed companies. The story is better for LBO-sponsored IPOs, which attained unprecedented heights on a global basis beginning in 2004. But, unlike VCs, "LBO sponsors do not have to take their companies public for them to succeed."[49]

Generally, a PE fund's investment in a PC proceeds in the following manner. In exchange for its cash, the fund receives an equity or equity-linked stake in the PC, generally in the form of convertible preferred stock and/or debentures with warrants and/or conversion privileges.[50] Like the LP interests issued by the PE fund, the PC securities are issued to the PE fund in a private placement, usually pursuant to the Rule 506 safe harbor under Regulation D.[51] Capital infusions are staged, and depend upon the PC meeting certain benchmarks. The typical

[46] Id.
[47] For a brief discussion of informed sellers and other disadvantages to buyers of transferred limited partnership interests, see Michael D. Smith, *A Second Look at the Secondary Private Equity Market*, J. OF PRIVATE EQUITY 55, 59 (WINTER 2001).
[48] Jason Draho, THE IPO DECISION: WHY AND HOW COMPANIES GO PUBLIC 47-48 (2004) 89-90 & 95.
[49] Jensen, supra note 21, 22.
[50] See generally, Jack S. Levin, supra note 19, Chapter 1 (2005).
[51] 17 C.F.R. § 230.506 (1983).

VC PC receives 2 to 3 rounds of financing at intervals of about one year.[52] As Paul Gompers notes, the role played by VCs' staged capital infusions is "analogous to that of debt in highly leveraged transactions, keeping the owner/manager on a 'tight leash' and reducing potential losses from bad decisions."[53] Thus, in exchange for their illiquid investment, VC and LBO funds obtain a high degree of control over the PC.

PE funds have a limited life, and the GPs who run them generally have their eyes on the exit from the moment of their initial investment. A shareholders' agreement may give the fund one or more seats on the board of directors, as well as the right for a number of years to veto or require an IPO or acquisition exit of the portfolio company.[54] In the colorful language of the trade, the fund may contract for "drag-along" rights—rights to force management to join in an acquisition exit of the portfolio company—"tag-along" rights—rights to participate pro rata in a sale of portfolio company securities by management—or "piggyback" rights—rights to participate in a public offering by the portfolio company or other equity holders, often with registration expenses paid.

IPOs traditionally have been the exit of choice for VCs. Because a public offering results in the highest valuation of a portfolio company, VC funds and their investors receive their highest returns from firms that go public.[55] This is the case even though VC funds do not "cash out" at an IPO (most underwriters require an insider lock-up period of six months).[56] In part,

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[52] Draho, supra note 48, 47-48.
[53] Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital,* 50 J. FIN. 1461, 1462 (1995).
[54] Alison S. Ressler, *Stockholder Arrangements in Private Equity Investments, in* PRIVATE EQUITY & VENTURE CAPITAL INVESTING: LEGAL, FINANCIAL & STRATEGIC TECHNIQUES FOR SUCCESSFUL INVESTING 117, 119-135 (Kurt J. Berney, et al., eds., 2001).
[55] Fenn, supra note 1, 34.
[56] Gompers & Lerner, supra note 7, 161; see also, Joshua Lerner, *Venture Capitalists and the Decision to Go Public,* 35 J. OF FIN. ECON. 293, 293-294 (1994). Luigi Zingales notes that a partial IPO exit at a short-term market peak may allow an initial owner—in this case, the VC fund—"to optimize the structure of his ownership in the company, so as to maximize his total proceeds from its eventual sale." In theory, a two-step sale—first, a public offering of

this may be due to the fact that VC funds apparently time the public equity markets, taking portfolio companies public when their valuations peak.[57] VCs also benefit indirectly from IPOs: increased VC fundraising in a given period is positively correlated with increased market value of VC-backed IPOs in preceding periods.[58] Less-experienced VCs in particular accrue reputational capital from a successful public offering.[59]

LBO funds find IPO exits attractive for the same reason as VC funds: the higher valuation available in the public capital markets provides them with greater profits than a private sale. Most LBO funds acquire their target companies with a goal of returning them to the public market within three to five years.[60] However, research reveals that the vast majority of these companies—86 to 95%—do not return to their prior lives as independent public companies.[61] However, an LBO fund does not need to undertake an IPO—a "reverse LBO"—in order to profit from its investment. In a study by Steven Kaplan, 60% of companies taken private had been "cashed out in some way" within 11 years, often by releveraging in a second LBO in which the company would borrow in order to repurchase the LBO fund's restricted securities.[62]

In recent years, public capital markets have afforded VC- and LBO-sponsored firms starkly different exit opportunities. As Figure 6 reveals, the "IPO window" has not reopened for U.S. VCs since the internet bubble burst in 2001. While the numbers differ depending on the source, the results are clear. Between 2001 and 2006 U.S. VC-backed firms raised only $15.83

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cash-flow rights, followed by a negotiated sale of control—should allow an initial owner to extract a greater total surplus from purchasers. See, *Inside Ownership and the Decision to Go Public*, 62 THE REVIEW OF ECON. STUDIES 3, 425, 426 (1995).

[57] Lerner, supra note 56, 294 (1994).

[58] Gompers & Lerner, supra note 12, 163.

[59] Indeed, less-experienced VCs take their portfolio companies public earlier than more-experienced VCs, which suggests that they are "grandstanding" in order to gain a reputation for success among potential investors in future funds. Gompers & Lerner, supra note 4, 160-161.

[60] Jensen, supra note 21, 22.

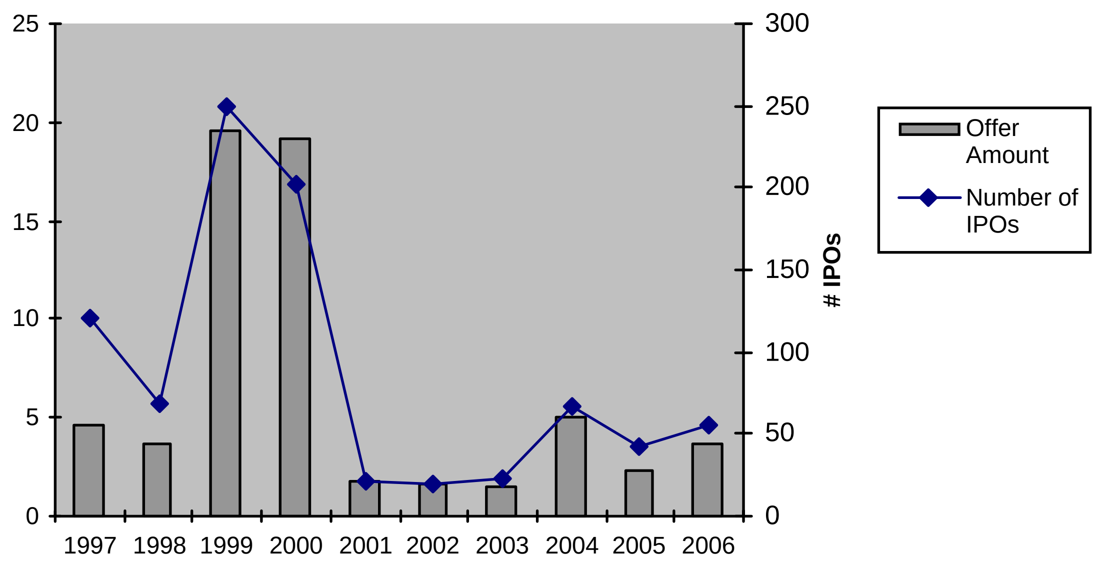
[61] Steven N. Kaplan, *The Staying Power of Leveraged Buyouts*, 29 J. of Fin. Econ. 287, 289 (1991) (86%); Chris J. Muscarella & Michael R. Vetsuypens, *Efficiency and Organizational Structure: A Study of Reverse LBOs*, 45 J. OF FIN. 1389-1414 (1990) (95%).

[62] Kaplan, supra note 61, 289 n. 5.

($28.42) billion in IPOs, compared to $38.71 ($38.8) billion in 1999 and 2000, according to Dow Jones VentureOne (Venture Economics/NVCA). In contrast, as Figure 7 shows, LBO-sponsored IPOs raised $56.6 billion globally between 2001 and 2006. As VC-backed IPOs stagnated, these "reverse LBOs" took off. In each year between 2004 and 2006, they accounted for more than 15% of total IPOs. However, the firms involved in these "reverse LBOs" were considerably older than previously was the case: the median age of the 2004-2006 firms was 16.2, 16.4, and 9.6, respectively, compared to 4.0 and 3.3 in 1999 and 2000. The 2004 and 2005 firms were older than in any year but 2001, when the median age was 22.7 years.

Both phenomena—the failure of the U.S. IPO window to reopen, and the advanced maturity of "reverse LBOs"—have played a role in the recent expansion of VC-backed

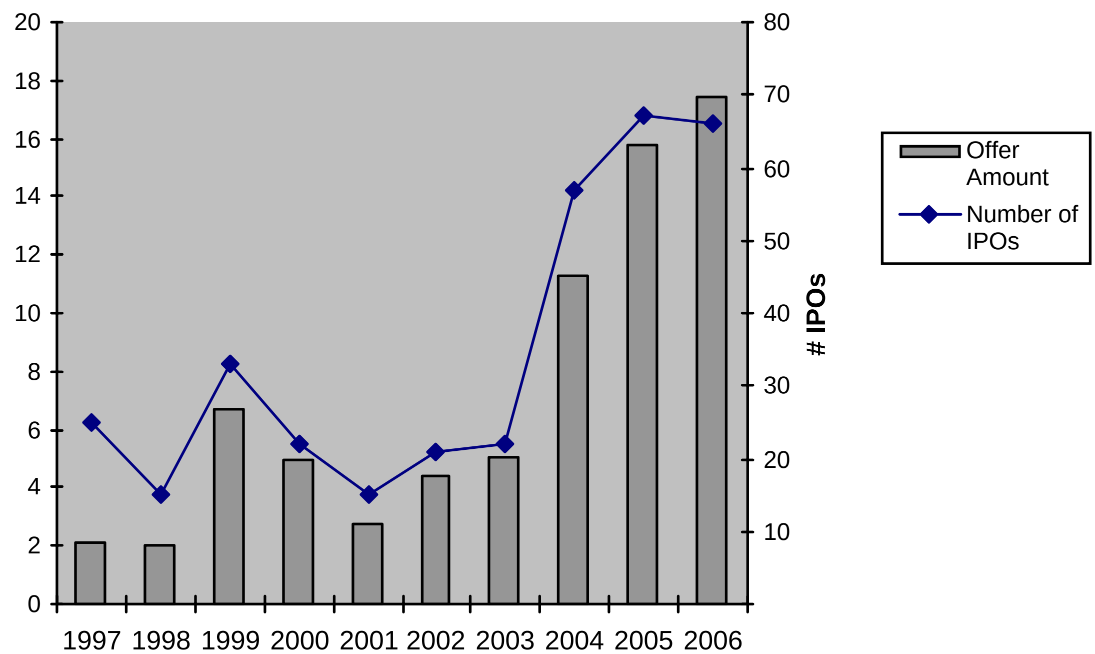
Figure 6: U.S. VC-backed IPOs, 1997-2006



Source: Dow Jones VentureOne

acquisition exits and "secondary buyouts." As discussed infra, use of these alternatives has grown dramatically since 2001. So much so, in fact, that one observer has wondered whether this "secondary market" in private equity is "the new stock market."[63] Acquisition exits and secondary buyouts are just one of the three new types of alternative liquidity technology transforming private equity and its relationship to public capital markets.

Figure 7: Global LBO-Sponsored IPOs, 1997-2006



Source: VentureEconomics/NVCA

III. SECONDARY MARKETS IN PRIVATE EQUITY: ALTERNATIVE LIQUIDITY TECHNOLOGIES

The section examines the emergence of three types of "alternative liquidity technologies,"[64] secondary markets in private equity that provide VC and PE funds and their investors with liquidity outside the traditional public equity markets. Part III.a considers acquisition exits and secondary buyouts, which allow VC and PE funds to exit portfolio

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[63] Lisa Bushrod, *Secondary Buyouts: The New Stock Market?* EUROPEAN VENTURE CAP. J. (July 1, 2005).
[64] I have borrowed the concept of transactional "technologies" from Guhan Subramanian, *Fixing Freeze-Outs*, 115 YALE L.J. 2, 17 (2005); and, Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L.REV. 811, 823 (2006).

company investments via mergers and acquisitions rather than IPOs. Part III.b examines the emergence of a vibrant market in "secondaries," limited partners' interests in private equity funds, now dominated by dedicated "vintage" or "secondary" private equity funds. Finally, Part III.c analyzes a novel secondary market in private equity: publicly-traded private equity vehicles that provide fund managers and investors with the liquidity characteristic of public companies, while promising the returns traditionally associated with private equity.

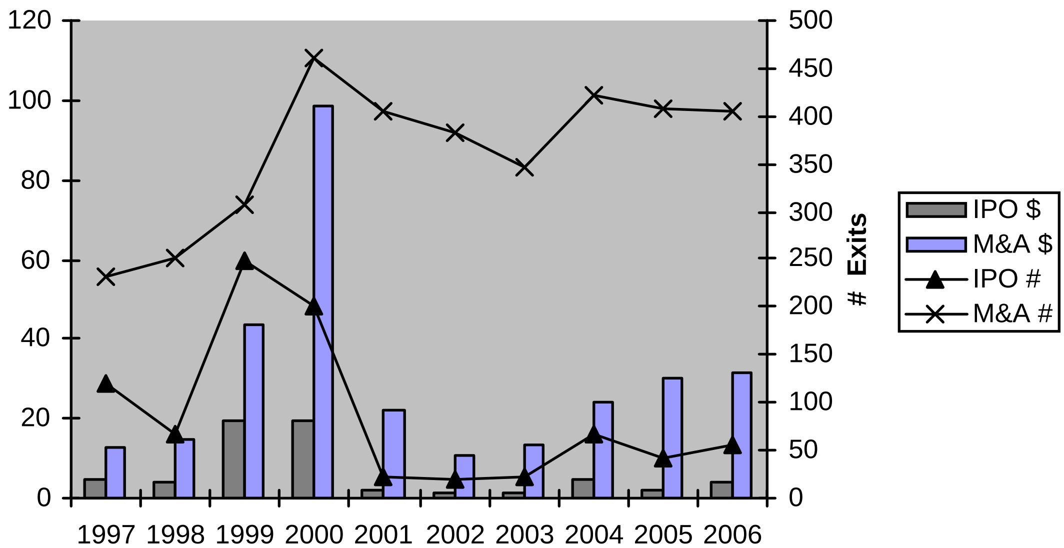
a. Acquisition Exits and Secondary Buyouts

Acquisition exits and secondary buyouts provide an alternative path to liquidity for VC and PE fund investments in portfolio companies. Both are species of mergers and acquisitions (M&A), and allow VC and PE funds to allocate business and legal risk precisely while exiting their investments completely (see infra IV.a). However, they differ in one essential aspect: the nature of the acquiror. VCs long have used acquisition exits to sell portfolio companies to strategic buyers (often public companies), who pay a premium to capture anticipated synergies. Secondary buyouts are a more recent phenomenon, and differ from acquisition exits insofar as the seller's counterparty is another financial buyer—another PE fund. Thus, secondary buyouts are the first true secondary market in private equity.

i. Acquisition Exits

While the IPO "window" has not reopened for VCs since the internet bubble burst, acquisition exits have recovered—in number, if not in average valuation. In truth, acquisition exits are a traditional, rather than alternative, liquidity technology for VCs. In the United States, acquisition exits have outnumbered IPO exits of VC-backed firms in every year since 1997 (Figure 8). Since 2001, the number of acquisition exits with disclosed values has exceeded the number of IPO exits by 10-to-1 (2367-to-230). The difference in the total value of these exits has been almost as great. From 2001 to 2006, VC-backed acquisition exits raised $131.48 ($80.59) billion, while VC-backed IPOs raised only $15.83 ($28.42) billion according to Dow Jones VentureOne (Venture Economics/NVCA).

Figure 8: U.S. VC Exits, 1997-2006



Source: Dow Jones Venture One

VCs sometimes may choose acquisition exits over IPOs for strategic reasons, insofar as the former allow immediate realization of their entire investment in a given portfolio company. However, VC-backed acquisition exits are not a true alternative to VC-backed IPOs. First, as discussed <u>supra</u> in II.c, VCs realize their greatest returns from IPOs, given the higher valuation of public equity markets. Second, even the valuation of acquisition exits is positively correlated with public equity markets. The average valuation of disclosed acquisition exits reached $77.18 ($103.18) million in 2006, a considerable recovery from recent lows of $28.56 ($52.11) million in 2002, according to Dow Jones VentureOne (Venture Economics/NVCA). While healthy, these average valuations are considerably lower than their peak of $214.07 ($221.14) million in 2000, at the height of the bubble. Finally, current returns on VC investment also are depressed by the increased investment required to realize an acquisition exit. In 2001, the median VC investment received by companies prior to acquisition increased from $10.4 to $14.9 million. It has continued to increase, reaching $23 million in 2006, according to Dow Jones VentureOne.

The close connection between the "IPO window" and VC-backed acquisition exits suggests that the latter are a complement to the former, rather than an alternative to public capital markets. For this reason, VCs are anxious about the bearish VC-backed IPO market, notwithstanding the bullish pace of acquisition exits. In the words of the National Venture Capital Association, "Venture capitalists depend on a strong capital markets system."[65]

ii. Secondary Buyouts

The return of LBO fundraising and primary investment since 2003 has been accompanied by the emergence of "secondary buyouts," sales of private companies from one LBO fund to another or to a syndicate of funds. Historically, secondary buyouts have been viewed as distress sales by both seller and buyer, to be avoided if possible. However, the vast influx of capital into private equity and the maturation of the private equity industry, on the one hand, and companies' recent difficulties in accessing public capital markets, on the other, have established secondary buyouts as a distinct niche in the private equity market. Secondary buyouts today are an alternative source of liquidity to LBO funds.

Secondary buyouts differ from typical acquisition exits of portfolio companies insofar as the seller LBO fund's counterparty is not a strategic buyer or a dispersed group of potential public shareholders, but another financial buyer seeking the same abnormal returns as seller, through similar means. Though secondary buyouts long have existed, both LPs and GPs previously have viewed these transactions negatively. To LPs, secondary buyouts have seemed

[65] National Venture Capital Association, 2005-2006 YEAR IN REVIEW (2007) 11. See also, National Venture Capital Association, *Venture-Backed IPO Market Languished While Acquisitions Market Maintained Bullish Pace in First Quarter of 2006* (April 3, 2006). Both available at http://www.nvca.org.

like "GPs shuffling assets among themselves, consolidating their own gains at the expense of investors."[66] An industry joke has a limited partner opening his mailbox to find letters from the general partners of two funds, one celebrating a profitable exit and the other touting a great investment, both referring to the same portfolio company. An insider's observation that LBO funds "eager to deploy capital before the expiration of their investment periods" may engage in secondary buyouts gives credence to such skepticism about GP incentives in such transactions.[67]

To GPs, secondary buyouts traditionally have been the "exit of last resort" from a target company, and a risky venture to enter.[68] As one GP put it, "The challenge with secondaries is that there's no low-hanging fruit anymore."[69] This increases the risk of the investment. For disclosed deals between 1996 and 2001, secondary buyouts failed 40% more often than primary buyouts.[70] Simmons Co., the bed manufacturer, is the poster child for the downside of secondary buyouts. It was bought and sold by private equity funds five times in twenty years, before finally going public in 2004. The proceeds of the IPO went entirely to refinance old debt.[71]

The market for secondary buyouts is beset by problems, the most basic of which derive from the opacity and complexity of the private equity market. For this reason, historically there have been few buyers for secondary buyouts. There is a fundamental "cherrypicking" problem—why is the first LBO fund selling *this* company, rather than *that* company? Thus, secondary buyouts require more due diligence, which means greater expense for the buyer, as well as both a longer transaction time and higher risk of non-consummation for the seller seeking

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[66] Lisa Bushrod, supra note 63.
[67] Todd Konkel, *Secondary Prices: A Rising Tide*, THE PRIVATE EQUITY ANALYST GUIDE TO THE SECONDARY MARKET 2004 10 (2004).
[68] Stephen Fraidin & William Sorabella, *Secondary Buyouts*, 1517 PLI/Corp 235 (2005).
[69] Peter Taylor of HarbourVest LLP, quoted by Lisa Bushrod, supra note 63.
[70] Fraidin & Sorabella, supra note 68.
[71] Neil Weinberg & Nathan Vardi, *Private Inequity*, FORBES (March 13, 2006).

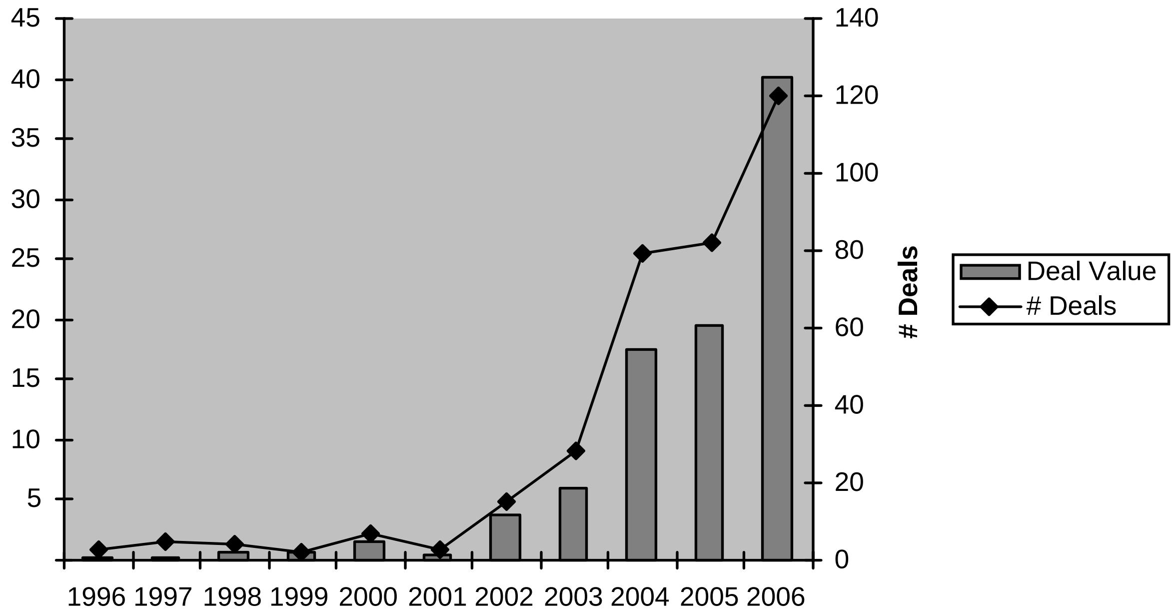
liquidity.[72] Even if the market were transparent, however, many funds either lack the ability to actively manage companies outside their industry focus or the resources to take on a new company mid-stream. For these reason, "secondary funds" strongly prefer to purchase LP interests or portfolios of LP interests, rather than to invest directly in portfolio companies.[73]

Despite these limitations, since 2004 secondary buyouts have increased dramatically in both number and value. Because many secondary buyouts are undisclosed, it is difficult to describe this market with complete accuracy. As Figure 9 shows, Thomson Financial records 82 announced secondary buyouts with a value of $19.46 billion in 2005. However, Dow Jones & Co. reportedly estimated 279 such deals, with a value of more than $33.2 billion, in 2005.[74] If the former figure is correct, secondary buyouts accounted for around 6% of global buyouts in 2005; if the latter, slightly more than 10%. In any case, what is remarkable is the way in which this secondary market has exploded alongside resurgent primary LBO activity. For 2006, Thomson Financial records 120 announced secondary buyouts with a value of $40.07 billion, a 100% increase in value over its 2005 figure. More than one observer has suggested that secondary buyouts demonstrate the coming of age of the private equity industry.[75]

The development of this secondary market is driven in part by endogenous factors. First, despite the heightened due diligence requirements, secondary buyouts are a much faster path to liquidity than IPOs.[76] Second, the private equity market's maturation has led to specialization, and the particular requirements of dealing in "secondary directs" have led to the creation of a market niche.[77] Given the liquidity needs of sellers who already have plucked the "low

[72] Columbia Strategy LLC, *Venture and Secondary Market Trends: Issues For Corporate Funds* (June 10, 2002).
[73] Id.
[74] Fraidin & Sorabella, supra note 68.
[75] Id. See also, Bushrod, supra note 63.
[76] Bushrod, supra note 63.
[77] Fraidin & Sorabella, supra note 68.

Figure 9: Global Secondary Buyouts, 1996-2006



Source: Thomson Financial

hanging fruit" from the portfolio company, buyers must be able to close a deal rapidly and be certain they can create value in a "cleaned up" investment in which they may hold a minority stake.[78] In addition to secondary buyouts between "primary" LBO funds—for example, KKR's sale of Borden Chemical, Inc. to Apollo Management for $1.2 billion in 2004—some firms now focus solely on secondary buyouts (e.g., Lake Street Capital).

However, most observers see three exogenous factors as the principle drivers of the secondary buyout market: the increased regulatory costs and legal risks of being a public company, the public capital markets' cooling toward new issues, and the current availability of inexpensive debt financing. The costs and risks associated with the Sarbanes-Oxley Act of 2002 (SOX) make going public less attractive to portfolio companies, and deter acquisitions of

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[78] Gretchen Knoell, et al., *Secondary Directs: How to Team with a Winner*, THE PRIVATE EQUITY ANALYST GUIDE TO THE SECONDARY MARKET 2004 (2004) 17-18.

portfolio companies by public companies that might have been strategic buyers.[79] Moreover, while the "window" for LBO-sponsored IPOs began to open in 2004, the public capital markets were closed to "reverse LBOs" for many years.[80] Secondary buyouts have become a particularly important exit for mid-sized companies.[81] By one estimate, secondary buyouts increased from 10% of mid-market exits in 2000 to 25% in 2005.[82] Finally, the availability of cheap debt has fueled the secondary buyout market, enabling LBO funds to offer the best price for portfolio companies at auction, and to purchase larger companies.[83] In the words of one GP, rather than go public, "We sell up the private equity food chain."[84] In an interesting twist, hedge funds have become "the ultimate buyer" in this secondary market in private equity.[85]

Secondary buyouts are not without legal risks, as Willis Stein & Partners, L.P., and ABRY Partners V, L.P., learned in 2004 and 2005, respectively. In March 2004, Willis Stein purchased Lincoln Snacks Co., maker of Fiddle Faddle, for an estimated $100 million from Brynwood Partners, which had taken the company private in 1999. By November 2004, Willis Stein had filed suit against Brynwood, alleging that the firm had misrepresented Lincoln's sales and cash flow, causing Willis Stein losses of more than $20 million.[86] In November 2005, ABRY filed suit against Providence Equity Partners over another secondary buyout gone sour.[87] This case is discussed at length infra in IV.a.ii. However, such (public) conflicts between LBO funds are rare, and certainly less costly or risky than shareholder lawsuits. Notwithstanding the

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[79] Fraidin & Sorabella, supra note 68.
[80] Id.
[81] Lisa Bushrod, *Public v. Private Equity*, EUROPEAN VENTURE CAP. J. (Nov. 1, 2005).
[82] James Stewart of ECI quoted in id.
[83] Id. See also, Fraidin & Sorabella, supra note 68.
[84] David Lobel of Sentinel Capital Partners, quoted in Ari Nathanson, *Secondary Doesn't Mean Second for LBOs*, BUYOUTS (Feb 28, 2005).
[85] Mark Vidergauz of The Sage Group LLC, quoted in id.
[86] Kenneth MacFadyen, *Brynwood vs Willis Stein Marches On*, BUYOUTS (Aug. 1, 2005); Kenneth MacFadyen, *Willis Stein Has Deal Spurt*, BUYOUTS (March 15, 2004)
[87] ABRY Partners V., L.P. v. F&W Acquisition LLC, 891 A.2d 1032 (Del.Ch. 2006).

flap over Fiddle Faddle, this secondary market in private equity is likely to become an even more significant link in the "private equity food chain" in the future.

b. "Secondaries" and Secondary Funds

Like the secondary buyout market, the market in "secondaries," resales of LP interests by existing private equity investors, has expanded and matured enormously in recent years. Like secondary buyouts, secondaries historically have served as an exit of last resort for private equity investors. However, where secondary buyouts provide liquidity for GPs and PE fund partnerships as a whole through direct company acquisitions, sales of "secondaries" provide liquidity for LPs, either through sales of individual LP interests or an LP's entire private equity portfolio. While the recent increase in secondary fundraising and investment is in part a cyclical response to the surge in primary private equity fundraising and investment between 1999 and 2001,[88] secondaries, like secondary buyouts, have "taken off." Secondaries have been transformed from a product of financial distress into an asset class traded by specialist funds and institutional investors seeking to actively manage their private equity portfolios.

i. "Secondaries"

Observers agree that the market in secondaries is, in reality, two markets. The first, "retail," market is comprised mainly of individual investors seeking to sell LP interests valued between $100,000 and $1 million, motivated principally by liquidity. The second, "institutional," market involves larger, more complex secondary transactions in which sellers are most often institutional or corporate investors motivated by portfolio strategy or other, non-liquidity interests.[89] While the former market remains dominated by opportunistic buyers and

[88] Sree Vidya Bhaktavatsalam, *Secondary Market Begins Fulfilling High Expectations in 2003*, THE PRIVATE EQUITY ANALYST GUIDE TO THE SECONDARY MARKET 2004 6 (2004).

[89] Byron T. Sheets, *Early Liquidity Alternatives in the Secondary Market for Private Equity Investors*, J. OF PRIVATE EQUITY, 57, 57 (Fall 1997).

distressed sellers, the latter has developed into a distinct market niche. Recently, it seems that sellers of portfolios with a net asset value of less than $25 million or purchase price of less than $15 million have found it difficult to attract the attention of secondary funds, discussed infra, which have focused increasingly upon acquisitions of large fund interests and portfolios.[90]

Enterprising firms have sought to address the deficiencies of this first, smaller market in "secondaries," with little success. Beginning in 2000, a handful of start-ups set out to provide investors with electronic marketplaces for the secondary exchange of private equity investments. However, these firms faced considerable difficulty in "remov[ing] the relationship from a relationship business."[91] The first functioning secondary exchange, PrivateTrade.com opened in May 2000. Sales remained small, and, in April 2002, PrivateTrade.com was acquired by a rival, the New York Private Placement Exchange (NYPPE).[92] NYPPEX, its web-based platform, provides scrolling price indications on restricted securities in both private companies and private funds.[93] However, like PrivateTrade.com, NYPPE has come to serve more as a broker-dealer and investment banking advisor than a true exchange.[94] Trading in the "retail" market in secondaries remains liquidity driven, largely informal, opaque, and inefficient.[95]

In contrast, the "institutional" market in secondaries is rather efficient. State pension funds in particular use the market in secondaries to manage their portfolios of private equity investments, driven by both political and financial motives. In 2004, the State of Connecticut Retirement Plans & Trust Funds (CRPTF) sold its limited partnership interests in four funds

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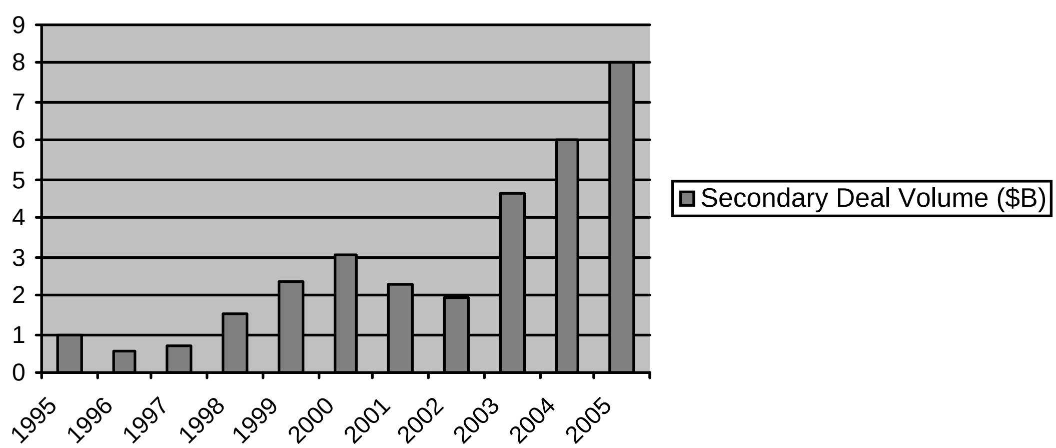
[90] Chuck Stetson, et al., *Making Money in Small Secondary Transactions*, THE PRIVATE EQUITY ANALYST GUIDE TO THE SECONDARY MARKET 2004 (2004) 24.
[91] Alistair Christopher, *Making an Entrance: Can Online Exchanges Find Their Place in the Secondary Market?* VENTURE CAP. J. (July 1, 2001).
[92] Vyvyan Tenorio, *Online Secondary Markets Strain to Capitalize on Boom*, THE DAILY DEAL (Nov. 8, 2001).
[93] See http://www.nyppe.com/History.aspx.
[94] Christopher O'Leary, *NYPPE Regroups And Changes Gears: Online Private Placement Network Downplays Online System, Emphasizes CPOs*, INVESTMENT DEALERS DIGEST (March 25, 2002).
[95] Id.

managed by buyout firm Triumph Capital Group to Coller Capital for $48.96 million.[96] CRPTF was driven to sell in the wake of a bribery scandal involving the State Treasurer and the managing partner and general counsel of Triumph. Driven by a strategy rather than scandal, the California Public Employees' Retirement System (CalPERS) decided in 2005 to restructure its Alternative Investment Management (AIM) program, the world's largest institutional investment program in private equity. As part of the overhaul, CalPERS created a "legacy portfolio" comprised of "non-core relationships, underperforming management teams, and retiring relationships" and indicated its intent to "explore opportunities to sell investments in the secondary market" beginning in the third or fourth quarter of 2006.[97]

This second market in secondaries has taken off since 2003. Sales of "secondaries," like secondary buyouts, often are undisclosed, making measurement uncertain. Nevertheless,

Figure 10: Global Secondary Deal Volume, 1995-2005



Sources: Lexington Partners, Private Equity Analyst (1995-2003); Triago (2004-2005)

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[96] State of Connecticut, ANNUAL REPORT OF THE TREASURER (2004) F-27. See also, Dan Primack & Matthew Sheahan, *Conn. Makes Secondary Sale; More States to Follow*, PRIVATE EQUITY WEEK (Nov. 22, 2004).

industry sources estimate that secondary deal volume reached $8 billion in 2005 (Figure 10). Secondary deal volume may increase as Nasdaq completes its revision of the Portal trading platform to provide price transparency in Rule 144A securities, in effect creating an NYPPE for institutional investors. John Jacobs, chief executive of Nasdaq global funds, also has suggested that this system would allow private equity and venture capital funds to exit their portfolio company investments in two stages, a Rule 144A private placement followed by a public offering.[98] Further development of the market in secondaries will allow institutional and corporate investors to continue to "move beyond a 'buy and hold' strategy for private equity.[99]

ii. Secondary Funds

Secondary funds dominate the buy-side of the institutional market in secondaries. The funds are limited partnerships that themselves commit to invest capital in an array of underlying VC and (more often) LBO funds in exchange for limited partnership interests in those funds (Figure 8). In a sense, secondary funds are a subcategory of "funds of funds" (FoFs).[100] As with an FoF, the GPs of a secondary fund leave the active management of the underlying portfolio companies to the primary VC or LBO fund GPs. However, where FoFs generally are passive investors seeking relatively diversified exposure to private equity as an asset class, secondary funds are actively managed, often opportunistic investors seeking to realize the same abnormal returns as "primary" funds.[101] Secondary funds negotiate secondary private placements directly with investors seeking early exit from their investments in primary private equity funds.[102]

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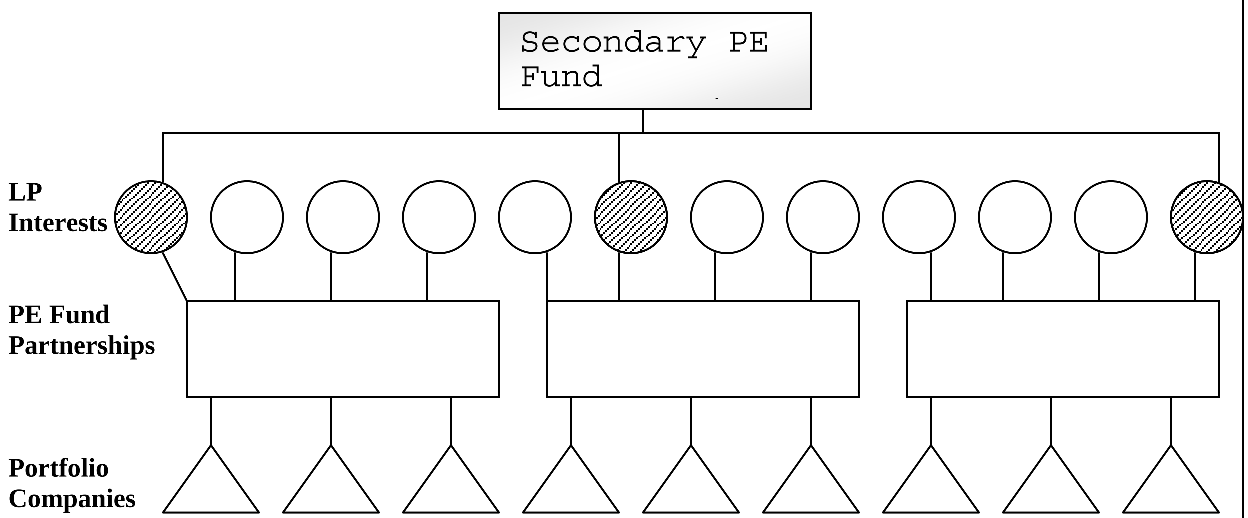
[97] CalPERS, *AIM 2005 Strategic Review: Proposed Action Plan* (Dec. 12, 2005) 6 & 12; CalPERS, *AIM Strategic Review Implementation Update* (June 19, 2006) 2. Both available at http://www.calpers.ca.gov. See also, Matthew Sheahan, CalPERS To Put Assets on Secondary Block, PRIVATE EQUITY WEEK (Dec. 19, 2005).
[98] Shanny Basar, *Nasdaq Opens Portal to Private Market Growth*, FINANCIAL TIMES (March 1, 2007).
[99] Antoine Dréan, *Towards a Market in Private Equity Interests*, PRIVATE EQUITY NEWS, February 6, 2006.
[100] Michael D. Smith, *A Second Look at the Secondary Market*, J. OF PRIVATE EQUITY, 55, 55 (Winter 2001).
[101] Id. at 57.
[102] Id. at 58.

Whereas the GPs of a FoF typically receive only a small "carried interest" on the fund's investments (usually 5%), secondary GPs generally take 20%.[103]

Figure 11: The Structure of a Secondary Private Equity Fund



Source: Michael D. Smith, *A Second Look at the Secondary Market*, J. OF PRIVATE EQUITY, 55, 56 (Winter 2001).

The first secondary fund was the Venture Capital Fund of America (VCFA) Group, founded in 1982.[104] However, until the late 1980s, this market remained small and, like the retail market in secondaries, informal and relatively opaque.[105] It was not until the early 1990s, when the first large secondary funds were raised and the first large portfolio purchases undertaken, that a secondary market in limited partnership interests truly emerged.[106] During most of the 1990s, however, the market in secondaries was populated overwhelmingly by distressed sellers, and dominated on the buy-side by 5 to 8 dedicated secondary funds able to privately negotiate purchases at steep discounts.[107] During the 1990s, sellers routinely

[103] Id. at 55.
[104] VCFA Group, *Providing Liquidity for Private Equity Investors* (Feb. 1, 2006).
[105] Sheets, supra note89, 57.
[106] Id. See also, *Secondary Market Timeline*, THE PRIVATE EQUITY ANALYST GUIDE TO THE SECONDARY MARKET 2004 28 (2004).
[107] Philip Borel, *High-speed Evolution*, PRIVATE EQUITY ANNUAL REVIEW 2005 68, 69 (2006).

discounted their LP interests by at least 30-50%.[108] This enabled most funds to realize annual returns of between 22.5-35%, with opportunistic returns exceeding 40%.[109] Thus, they often were called "vultures."

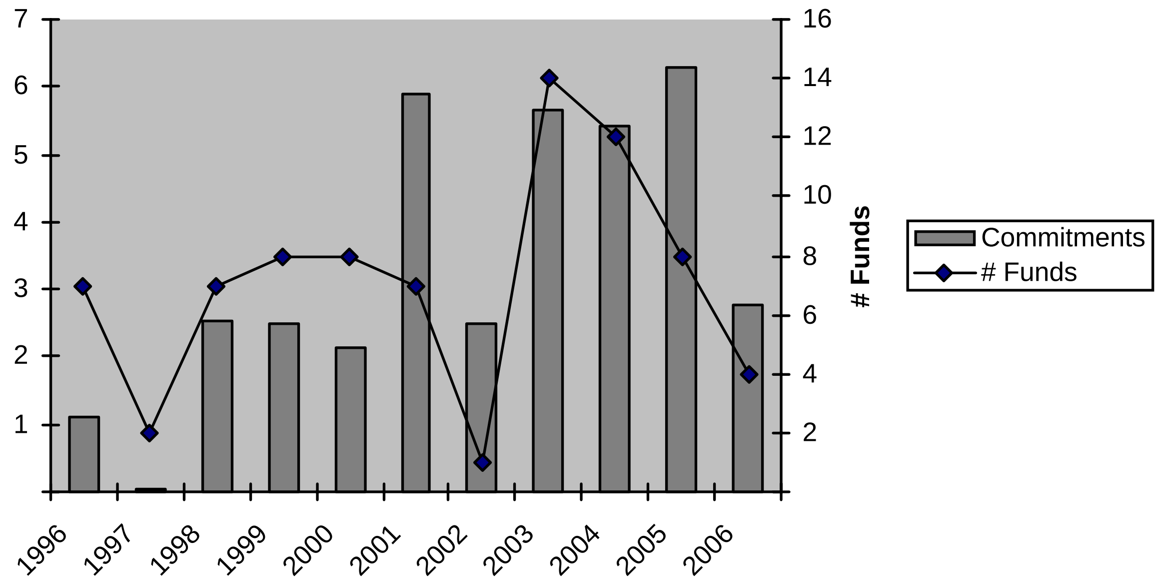
Secondary funds—now called "vintage" funds—have grown and transformed since 2001, when secondary fundraising reached nearly $4 billion—more than doubling over the previous year. Fundraising has been healthy every year since 2002, both in terms of aggregate fund commitments—more than $20 billon from 2003-2006—and the size of individual funds (Figure 12). In 2006, Lexington raised the cap on Lexington Capital Partners VI, its largest secondary fund to date, from $2.5 to $3 billion.[110] Diversified financial institutions have begun to raise their own dedicated secondary funds, most notably Goldman Sachs' GS Vintage Fund IV, which raised $3 billion in 2007.[111] As in "primary" private equity, the size of deals has grown with the funds. In 2003, UBS sold a $750 million secondary portfolio to HarbourVest Partners LLC.[112]

As secondary funds have grown, the market in secondaries has become more efficient. The influx of capital into secondary funds, along with the entrance of nontraditional buyers of secondaries and greater market transparency, has eliminated the deep discounts and outsized returns of the 1990s.[113] Today, sellers offer discounts of less than 20% of net asset value and the average internal rate of return to secondary funds is between 15%-25%.[114] Indeed, at least one

[108] Id. at 68.
[109] Id. at 69.
[110] Matthew Sheahan, *Lexington Ready to Finalize Record Fund*, VENTURE CAPITAL JOURNAL (March 2006) 23.
[111] Heidi Moore, *Wall Street Bank Raises $3bn Secondaries Fund*, FINANCIAL NEWS US ONLINE (March 20, 2007), available at http://www.financialnews-us.com.
[112] Bhaktavatsalam, supra note 88, 5.
[113] Smith, supra note 47, 60. Borel, supra note 107, 68.
[114] Borel, supra note 107, 69.

commentator now worries that the secondary funds, rather than the selling limited partners, are receiving a raw deal—"buyout scraps."[115]

Figure 12: Global Secondary Fund Commitments, 1996-200



Source: Venture Economics/NVCA

The rise of secondary funds in recent years is part of a the general "take off" of the market in secondaries. As the market has grown, it has become more complex, a reflection of the opportunities presented by this new liquidity option and the motives of market participants. As noted supra, seller goals have changed. Institutional and corporate investors utilize the secondary market to actively manage their private equity portfolios.[116] Sellers also seek to reduce their exposure to private equity as an asset class, in order to minimize administrative costs or meet asset allocation targets.[117] Secondary buyers still seek distressed sellers, of course. However, buyer goals, particularly those of the LPs who invest in secondary funds, also have

[115] Lauren Silva, *Buyout Scraps*, BREAKINGVIEWS.COM (March 27, 2007), available at http://www.breakingviews.com/freestory.aspx?e=c0i2pCQ3yCu.
[116] Id. See also, Smith, supra note 47, 56.
[117] Sheets, supra note 89, 58-59.

changed. Many LPs invest in secondary funds in order to manage their cash flow, mitigate risk by investing in a fund that is no longer brand new, and achieve "vintage diversification" by gaining exposure to private equity funds raised and invested over a number of different years.[118]

In order to meet the diverse needs of buyers and sellers, secondary market participants have developed tailored liquidity options. Many secondary deals now involve the acquisition of an institutional investor's private equity portfolio, or large portion thereof, sometimes utilizing substantial leverage—a secondary LBO.[119] However, even in smaller secondary transactions, buyers and sellers have used contractual arrangements and restricted securities to culminate their deals. In a "staged liquidity" sale, sellers transfer their entire LP interests to the buyer, who pays the (higher) purchase price over a number of months or years. An increasing number of deals also involve equity warrants, which allow the seller some measure of participation in the upside of the LP interest for sale.[120] While it may not be the "new stock market," the institutional secondaries market is a true secondary market in private equity.

c. <u>Publicly Traded "Private" Equity Vehicles</u>

Since 2004, a number of large private equity firms have formed publicly traded private equity vehicles. The movement began in April 2004, when Apollo Management LP launched an IPO for Apollo Investment Corporation (AINV), a closed-end, nondiversified management investment company which trades on Nasdaq as a business development company (BDC).[121] The limitations of BDCs led U.S.-based private equity firms to develop alternative liquidity technologies. In 2006, Kohlberg, Kravis, Roberts & Co. (KKR) and Apollo launched IPOs on Euronext Amsterdam for vehicles similar to BDCs, though subject to considerably less

[118] Smith, <u>supra</u> note 47, 58.
[119] Konkel, <u>supra</u> note 67, 9.
[120] Sheets, <u>supra</u> note 89, 60.
[121] David Carey, *Apollo Raises $930M in IPO*, THE DAILY DEAL, April 7, 2004.

regulation. In 2007, Fortress Investment Group (FIG), a hedge fund and private equity manager, and Blackstone Group, a private equity firm, sold stakes in their management businesses through IPOs in the U.S. These new technologies respond to the limits of BDCs and inaugurate a new era in the relationship of private equity to public capital markets.

i. Business Development Companies

Strange as it might seem, the highly regulated BDC is a creature of deregulation. As discussed infra at IV.c.i, Congress establish an alternative regulatory schema for BDCs in 1980 in order to provide venture capital and private equity funds with access to public investors.[122] According to the terms of the 1940 Act, a BDC is a closed-end investment company with more than seventy percent of its portfolio invested in restricted securities or distressed firms (or cash). The statute exempts BDCs from most of the regulations applied to an "investment company."[123] BDC securities trade like public equity, and are subject to the same reporting requirements under the 1934 Act.[124] Like a partnership, a BDC is exempt from entity-level taxation if it distributes 90% or more of their income to shareholders as dividends.[125]

Despite these advantages, BDCs are a flawed public vehicle for private equity investment. First, as discussed infra at IV.c.i, BDCs remain subject to onerous regulatory requirements, foremost among them the stringent asset allocation limits of the 1940 Act and the dividend distribution requirements of the U.S. federal tax code. Second, like the closed-end funds of the 1970s, BDC shares often have traded at substantial discounts to net asset value, a

[122] 15 U.S.C. § 80a-6(f). See, generally, Reginald L. Thomas & Paul F. Roye, *Regulation of Business Development Companies under the Investment Company Act*, 55 S.CAL.L.REV. 895, 912-929 (1982).
[123] 15 U.S.C. §§ 80a-2(48) & 80a-55(a).
[124] Kathy A. Fields & Edwin C. Pease, *BDCs: Is Private Equity Going Public?* available at http://www.tht.com.
[125] Id.; see also, Carey, supra note 121.

reflection of the longer investment horizon needed to realize returns on illiquid private investments. “Only a handful” of private equity funds have registered as BDCs.[126]

Apollo’s 2004 launch of AINV, which raised $930 million from public investors, sparked a short-lived boom in BDC registrations. Thirteen BDCs filed registration statements with the Securities and Exchange Commission by the end of May 2004.[127] However, AINV’s stock dropped 15% immediately following its IPO most of these registration statements were withdrawn.[128] This lackluster initial market performance and the refusal of Goldman Sachs and Morgan Stanley to underwrite BDC IPOs that might subject them to lawsuits by frustrated retail investors took the wind from the sails of these public vehicles.[129] Nevertheless, AINV was followed by a few other notable private equity IPOs, including KKR’s public offering of shares in KKR Financial Corp. (KFN), a Real Estate Investment Trust (REIT), in June 2005.[130]

Not all BDCs launched in 2004 and 2005 have disappointed; however, neither have they provided an adequate publicly traded vehicle for private equity investment. In the end, AINV recovered from its initial lows and provided investors with returns of 12.9% in the fiscal year ended March 31, 2006, and a total return of 33.5% since its IPO, assuming reinvestment of dividends.[131] In addition to these positive returns, AINV, which invests almost exclusively in debt and engages heavily in private non-investment grade financing, provides public investors access to investment returns uncorrelated with publicly traded equities. However, these investments are not in private equity, but subordinated debt financing. Such an investment

[126] Levin, supra note 19, ¶ 1008.
[127] Fields & Pease, supra note 124.
[128] Dan Primack, *2004 Timeline*, BUYOUTS, Jan. 3, 2005.
[129] Vipal Monga, *Goldman, MS Say No to BDCs*, THE DAILY DEAL, May 27, 2004.
[130] KFN technically is not a BDC, but a REIT, and is exempted from “investment company” regulation by section 3(c)(5)(C) of the 1940 Act. 15 U.S.C. § 80a-3(c)(5)(C). However, the securities regulation and federal taxation of REITs is similar to that of BDCs, subjecting them to asset allocation and dividend distribution requirements.
[131] Apollo Investment Corp., ANNUAL REPORT 2006 (March 31, 2007) 3; see also, *How Apollo Investment’s Stock Became Godly*, WALL.ST.J. (July 20, 2005).

strategy is a sensible one for a BDC, insofar as it lowers the volatility of returns. AINV's strategy matches cash inflows from fees and interest payments to the cash outflows of is quarterly dividends. As a vehicle for public investment in private equity, the BDC has been surpassed by new liquidity technologies.

ii. Initial Public Offerings in Europe

In Spring 2006, two successful U.S. private equity firms, Kohlberg Kravis Roberts & Co. and Apollo, launched publicly traded private equity vehicles on Euronext Amsterdam N.V. These vehicles, KKR Private Equity Investors (KPE) and AP Alternative Assets (AAA), raised $5 and $1.5 billion of permanent capital, respectively, for investment in and alongside traditional KKR and Apollo private equity funds,[132] and sparked considerable discussion of the merits of "private equity go[ing] public."[133] KPE and AAA are publicly traded, closed-end investment companies that establish a permanent pool of capital for private investment, while offering public investors the option of exit into a liquid secondary market. As such, they are quite similar to BDCs, and have suffered from some of the same problems—both traded at discounts to their IPO prices for most of 2006. However, because they are governed by foreign laws and listing standards, they are subject to none of the regulations applied to BDCs in the U.S. While lukewarm investor response to AAA signaled an end to "BDC" IPOs in Europe (at least in 2006-2007), [134] these vehicles opened the door to a new type of private equity IPO in the U.S. Because KPE and AAA are nearly identical, this section will discuss the structure of KPE. The rules and regulations governing these vehicles are discussed in detail infra, at IV.c.ii.

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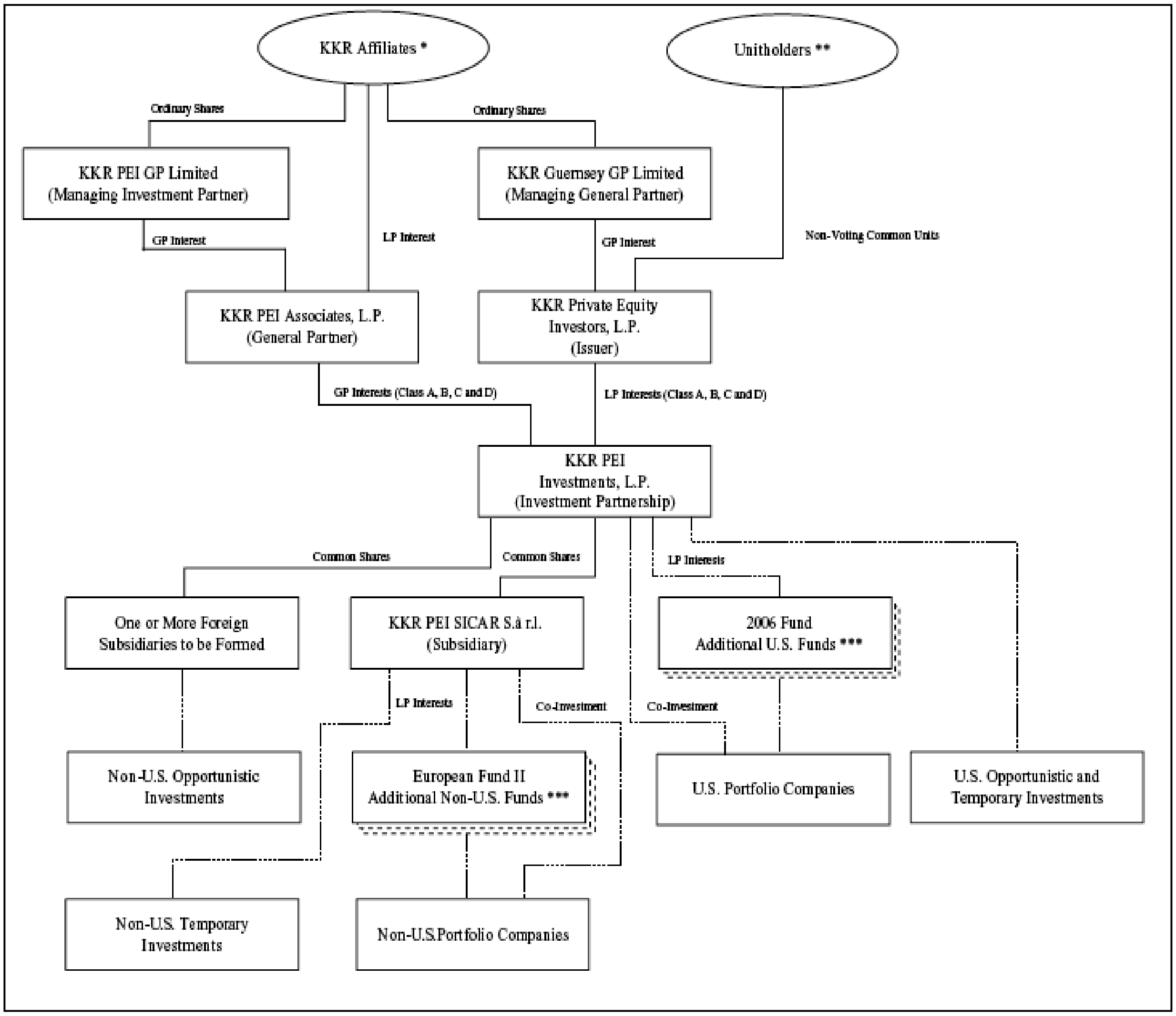
[132] Henry Sender, *KKR's $5 Billion IPO Experiment*, WALL ST. J., May 2, 2006, at C1. Henny Sender, *Kohlberg Kravis Aims To Raise $1.5 Billion With a Listed Fund*, WALL ST. J., Apr. 19, 2006, at C3.
[133] Heather Timmons, *Private Equity Goes Public for $5 Billion: Its Investors Ask, "What's Next?"* N.Y. TIMES (Nov. 10, 2006)
[134] AAA was forced to lower its offering amount from $2.5 to $1.5 billion due to weaker than expected investor interest. Commentators attributed investors' wariness to "sour grapes" over KPE's low post-IPO stock price Id.

KPE is a closed-end investment fund structured as a limited partnership under the laws of Guernsey, and makes its investments exclusively through a separate, wholly owned Guernsey limited partnership (KKR PEI Investments, L.P.; "KPEI") and its subsidiaries. While Figure 13, taken from KPE's Preliminary Offering Memorandum,[135] depicts an entity of some complexity, its essence is quite simple: KPE is an "evergreen" Fund of Funds (FoF) dedicated mainly to investing in and along side KKR funds and purchasing secondaries from existing KKR LPs. According to the terms of its limited partnership agreement, KPE must invest at least 75% of its assets in KKR-sponsored private equity investments.[136] KPE differs from a simple KKR FoF or

Figure 13: Ownership, Organizational, and Investment Structure of KPE

[135] KKR Private Equity Investors, L.P., PRELIMINARY OFFERING MEMORANDUM (April 18, 2006) 48.
[136] Id. at 1.



BDC insofar as it may invest up to 25% of its assets in "opportunistic investments," including publicly traded securities. However, the Offering Memorandum contemplates that many of these investments would be made alongside KKR Strategic Capital Fund, a new KKR entity focused on stressed and distressed debt investing.[137]

KPE is structured as follows.[138] After the global offering of common units to investors in the Netherlands and restricted depository units (RDUs) to investors in the U.S., unitholders are in the position of LPs in KPE. KPE, in turn, invests the proceeds of the offering in KPEI, which

[137] Id. at 85.
[138] The following description draws from id. at 48-54.

actually makes investments in underlying KKR private equity funds. These KKR funds, in turn, invest in portfolio companies according to the usual practice, described supra in II.b. In effect, KPE combines the small investments of each unitholder to create a single, giant LP invested in KPEI, a KKR FoF. For tax reasons, KPEI makes non-U.S. investments through foreign subsidiaries. Thus, KPEI invested directly in KKR's 2006 Fund, but purchased a secondary LP interest in KKR's European Fund through KKR PEI SICAR, its Luxembourg subsidiary. All of the KPE entities are party to a services agreement with KKR—the Delaware limited partnership that manages all KKR investments—pursuant to which KKR undertakes the day-to-day management of all portfolio companies in exchange for a management fee.

The governance of KPE is a hybrid blend of private equity and public corporation. Like LPs in any other KKR fund, unitholders in KPE have no management, control, or voting rights. Their investment fund, KPEI, is managed by a general partnership, in this case KKR PEI Associates, L.P.[139] This entity owns GP interests in KPEI that give it the right to receive incentive distributions and carried interests on KPEI's investments, and thereby participate in the returns to these investments. However, unlike a traditional private equity fund, KPE itself is managed by a GP with only a *de minimis* economic interest in it, KKR Guernsey GP Limited. This entity functions as KPE's board of directors, the majority of which is comprised of independent according to New York Stock Exchange (NYSE) standards.[140] Though KPE is not subject to SOX requirements, independent directors comprise the entirety of its audit committee and the majority of its nominating and corporate governance committees.[141] However, this board is not elected by KPE unitholders, but by the shareholders of the KKR Guernsey GP

[139] In fact, KPEI is managed by the GP of its GP fund, KKR PEI GP Limited, which acts as the Managing Investment Partner. This distinction is irrelevant to our inquiry.
[140] Id. at 110.
[141] Id. at 113.

Limited—KKR affiliates.[142] Moreover, it has no authority: its main tasks are to oversee the preparation of KPE's periodic filings and monitor managers' compliance with KPE's limited partnership agreement. The board of KPEI's Managing Investment Partnership, which actually manages unitholders' investments in KKR funds, is composed entirely of KKR affiliates, who are elected by its shareholders—KKR affiliates.[143] Thus, KPE unitholders have all the protection of SOX and NYSE "independence" rules, and none of the power of the shareholder franchise.

KPE's unitholders have different rights than LPs in a traditional private equity fund or shareholders in a public company.[144] Because KPE common units, like common stock, must be fungible in order to trade freely in the secondary market, unitholders part with their full investment upon acquisition of the securities and have no right to withdraw funds under any circumstances. In contrast, LPs in a traditional fund are not required to fully fund their investments at commencement, and have the right to withdraw their capital under certain conditions, such as the departure of a "key man." At the same time, KPE's unitholders receive less information about the investments made by KPEI and the underlying funds in which it invests than would either a public company shareholder or a private equity LP. In the U.S., either a shareholder or an LP would receive annual and quarterly reports about the financial status, operating performance, and prospects of the entity and its subsidiaries. Both also would receive periodic disclosures of material events. A KPE unitholder will receive annual and quarterly reports that include the consolidated financial statements of both KPE and KPEI; however, these reports only disclose the valuations of KPEI's interests in underlying KKR funds and those portfolio companies representing at least 3% of KPE INV's net asset value (a $150

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[142] Id. at 110.
[143] Id. at 118.
[144] Id. at 28-30.

million investment, if net asset value is $5 billion). KPE's 2006 Financial Report discloses three significant portfolio company investments, but reports only the cost and fair value of each. It includes no operating information or management discussion and analysis of the companies' performance and prospects.[145]

The fees and carried interest paid by KPE's unitholders further distinguish them from LPs of a traditional PE fund or FoF.[146] In short, KKR is paid more, sooner. First, the management fee paid to KKR is based on a simple percentage formula of KPE's "equity"— its net asset value—which is likely to grow over time as KPE retains earnings. In contrast, the rate of fees paid by LPs of a KKR private equity fund would decline as its invested assets grew. Thus, the success of KPE's investments results in a double windfall to KKR, first in the form of greater fees, then in a carried interest. This provision puts KPE's provisions restricting "double dipping" in perspective. According the partnership agreement, the 20% carried interest due to KKR PEI Associates, L.P., on KKR and KKR-sponsored private equity investments is reduced by distributions already made to an affiliate of KKR.[147] Thus, unlike LPs to a traditional secondary fund or FoF, KPE unitholders do not pay an additional layer of "carry." However, the steady, rising stream of management fees likely will balance the loss of this carry. According to the services agreement, KKR would earn $57.5 million annually from the $5 billion fund.[148]

Second, the standard 20% carried interest owed to KPEI's GP on the net realized returns from the fund's successful private equity investments is supplemented by an annual 20% incentive distribution on the appreciation in the net asset value of its opportunistic and temporary

[145] KKR Private Equity Investors, L.P., 2006 ANNUAL FINANCIAL REPORT (March 27, 2007) 3.
[146] Id. at 28-30.
[147] Id. at 6.
[148] Notably, KPE's management fee will not be reduced by transaction fees, break-up fees, and management fees paid to KKR by portfolio companies, as would the fees paid by limited partners of a KKR fund. Id. at 28-30.

investments.[149] Thus, for example, KKR PEI Associates, L.P., may collect 20% of KPE's unrealized gains on its purchase of senior convertible bonds issued by Sun Corporation after one year, even if KPE has not sold the bonds.[150] Similarly, secondaries purchased from KKR LPs are considered opportunistic investments. When it purchases one at a discount one at a discount, KPEI is credited with an immediate gain; thus, the GP may take 20% of this "gain" in its annual incentive distribution.[151] In contrast, the GP of a traditional secondary fund takes its carry on the gain attributable to the purchase of a discounted secondary only when it is realized by the fund.

In effect, KPE unitholders hold a security that is at least as risky as an LP interest in a KKR private equity fund,[152] with fewer rights. For this privilege, they compensate KKR with bigger, steadier fees and a larger, earlier carried interest than would a traditional LP. Furthermore, the structure of KPE may create the very "free cash flow" problem that private equity investment generally cures.[153] KPE is a dedicated $5 billion fund that will grow as proceeds are reinvested, an "evergreen" source of capital that may be invested in or alongside new KKR funds, regardless of the relative merits of doing so. Or, KPE's capital may be paid to existing funds and LPs of those funds in order to provide their partial exit from portfolio company investments, or the fund itself — "evergreening" prior KKR investments. In addition, the annual incentive distribution paid on KPE's opportunistic and temporary investments provides KKR with a steady stream of cash flows, lifting some of the discipline imposed upon managers by the structural illiquidity of private equity. Perhaps awareness of these agency costs

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[149] Id. at29.
[150] Emily Thornton, *Private Equity Goes Public*, BUSINESSWEEK (March 19, 2007) 76.
[151] KKR Private Equity Investors, L.P., PRELIMINARY OFFERING MEMORANDUM (April 18, 2006) 52.
[152] Assuming, as seems reasonable, that investing in and alongside multiple KKR funds does not diversify away the idiosyncratic risk of investing in private equity with KKR.
[153] Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. R. (September-October 1989) (Revised 1997), 9, *at* http://papers.ssrn.com/abstract=146149.

contributed to the disappointing performance of AAA, which was forced to lower its offering amount by $1 billion.[154]

Of course, both private equity funds and investors are keenly attuned to the costs and benefits associated with publicly traded private equity vehicles. In creating KPE, KKR sought to mitigate agency costs by aligning its partners' incentives with those of KPE unitholders: KKR must use 25% of pre-tax distributions made on its carried interest and incentive distributions from KPE to purchase additional KPE common units.[155] Ultimately, however, KPE unitholders accept these constraints and costs in exchange for access to KKR's deal flow and management expertise, as well as secondary market liquidity for their securities. Indeed, it is not entirely clear whether some "costs" are, in fact, costs. For example, the weak voting rights of KPE unitholders allow the fund's managers to focus on long-term strategy, which has served KKR LPs quite well.

What is clear, however, is that willing public investors in Europe may put themselves in the position of an LP in a KKR fund. Though the positive abnormal returns associated with KKR have yet to materialize for KPE, private equity investing may fulfill the investor's desire for further diversification or his taste for skewed returns. In any case, if he is disappointed, he may exit into a liquid secondary market. Because of U.S. securities law (discussed infra at IV.c.ii), a public investor in the U.S. may not make the same investment, at least outside a vehicle regulated as a BDC. However, he may take the position of a quasi-GP by investing in one of the new technologies described infra.

iii. Initial Public Offerings in the United States

In early 2007, two successful alternative asset managers planned to undertake IPOs in the U.S. In February, Fortress Investment Group (FIG), a U.S.-based hedge fund and private equity

[154] Timmons, supra note 133.
[155] KKR Private Equity Investors, L.P., PRELIMINARY OFFERING MEMORANDUM (April 18, 2006) 1.

manager, sold a ten percent stake in its asset management business for $634 million.[156] In March, Blackstone Group, a U.S.-based asset manager focused on large private equity and real estate investments, announced its plan to undertake a $4 billion offering of shares in the Blackstone Group, L.P. (BX).[157] Unlike KPE and AAA, these publicly traded private equity vehicles do not form an "evergreen" FoF for Fortress and Blackstone affiliates to invest. Instead, FIG and BX place public investors in the position of "passive" private equity GPs, allowing them to share in the fees and carried interest earned managing the underlying "family" of funds.

Far more than BDCs or the European IPOs, FIG and BX challenge the traditional distinction between private equity and public equity markets. These publicly traded private equity vehicles are hybrid entities, public companies that retain many of the features that have made contributed to the success of private equity investing. In a sense, they are the new conglomerates, the permanent realization of Brealey, Myers, and Allen's famous description of private equity partnerships as "temporary" conglomerates.[158] Because FIG and BX are nearly identical, this section will discuss the structure of BX. The current rules and regulations governing these vehicles are discussed in detail infra, at IV.c.iii.

BX is a master limited partnership formed under the laws of Delaware. It is a "holding partnership" that, through five wholly-owned subsidiaries (Blackstone Holdings I GP through Blackstone Holdings V GP), owns partnership interests in five underlying Blackstone Holdings partnerships (Blackstone Holdings I L.P. through Blackstone Holdings v L.P.; "Blackstone Holdings"). Blackstone Holdings, in turn, owns partnership interests in and controls

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[156] Fortress Investment Group LLC, Form S-1/A (Feb. 2, 2007) 1; Ben Maiden, *First Hedge Fund IPO Reveals Industry's Future*, INT'L.FIN.L.REV. (Nov. 15, 2006); Alex Halperin, *Investors Storm Fortress IPO*, BUSINESSWEEK (Feb. 9, 2007).
[157] Dennis K. Berman & Henny Sender, *Big Buyout Firm Prepares to Sell Stake to Public*, WALL.ST.J. (March 19, 2007) A1; Martin T. Sosnoff, *The Blackstone Comet*, FORBES.COM (March 30, 2007).
[158] Richard A. Brealey, Stewart C. Myers & Franklin Allen, PRINCIPLES OF CORPORATE FINANCE (8 ed. 2005) 920-921.

Blackstone's operating entities, its private equity, real estate, hedge fund, and financial advisory businesses. The operating entities act as GPs to Blackstone's actual private equity funds, which invest LP capital in portfolio companies and elsewhere according to the usual practice, see supra II.b, and receive management fees, incentive distributions, and carried interests in return.

Whereas KPE is rather simpler it appears in Figure 13, BX is more complicated than is revealed by Figure 14, taken from BX's preliminary prospectus.[159] In forming KPE, KKR affiliates simply established the functional equivalent of a new private equity limited partnership, a Fund of Funds for public investors. In contrast, Blackstone Group's founders, senior managing directors, and other existing owners have undertaken a complete reorganization of their private equity businesses in order to create BX. The existing owners have contributed the operating entities of Blackstone Group—principally, the managing GPs of most of Blackstone Group's private equity, real estate, and hedge funds—to Blackstone Holdings. In exchange, they have received vested and unvested partnership units in Blackstone Holdings, which may be exchanged for publicly traded units of BX on a one-for-one basis (when vested). Blackstone Group's senior managing directors also have formed Blackstone Group Management LLC (BX LLC), a Delaware LLC that serves as GP of BX. While this entity has no economic interest in BX, it controls its investments, and is owned and controlled by Blackstone's senior managing directors. The end result of this reorganization is an asset management business similar to Goldman Sachs or Morgan Stanley, control of which is irrevocably granted to its managers (who also continue to own a large stake in its operating businesses). As noted supra, public investors in BX are in the position of peculiarly passive GPs.

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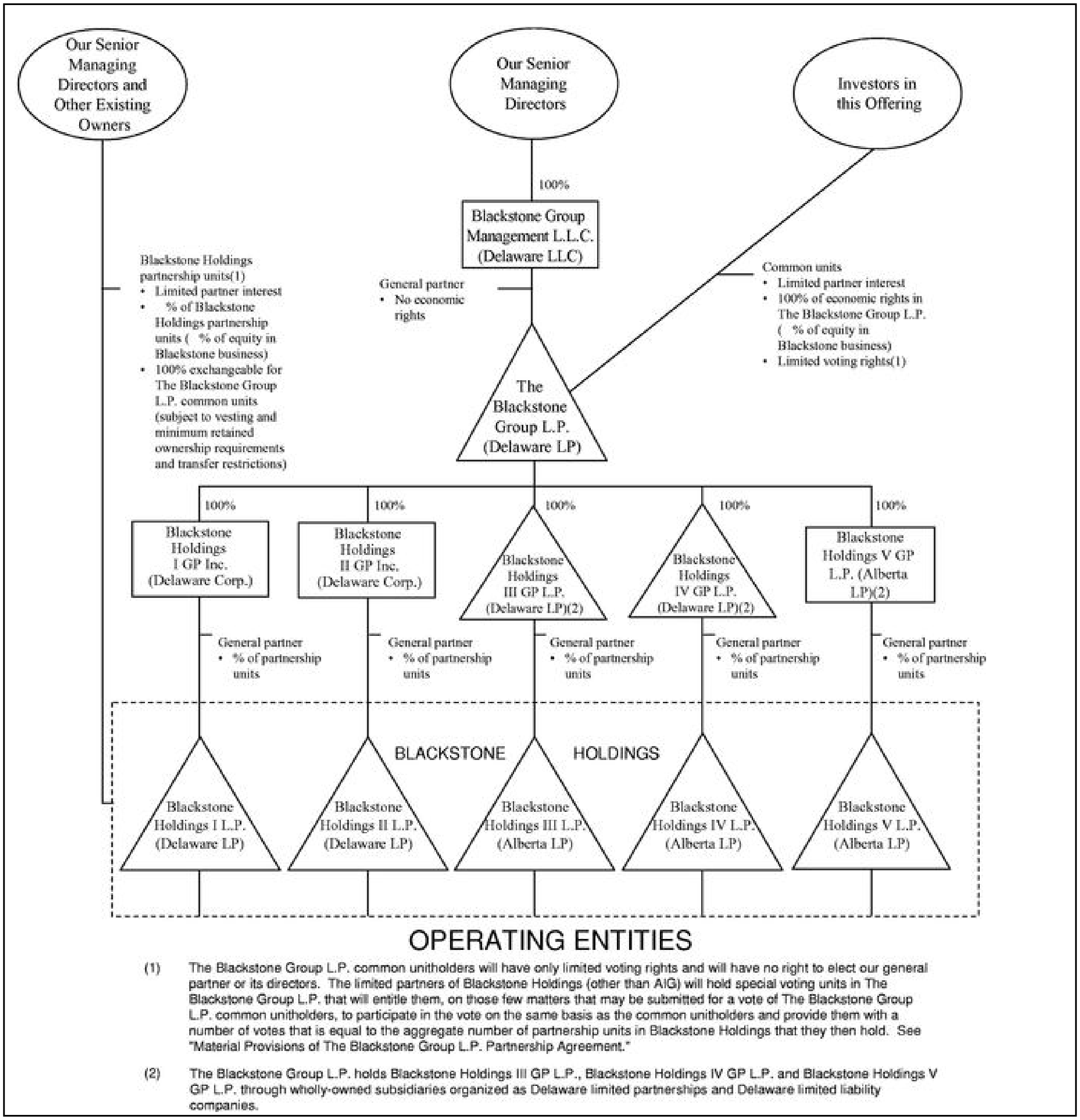
[159] The Blackstone Group, L.P., FORM S-1 (March 22, 2007) 62. Most of the following is based on pages 57-64.

Figure 14: Ownership, Organizational, and Investment Structure of BX



Because BX is a limited partnership with a GP, it is exempt from NYSE governance rules that would have required it to have a majority of independent directors on its board of directors, and entirely independent compensation and nominating/corporate governance committees. Instead, the board of BX LLC, the GP of BX, consists of seven directors, four of whom are management directors.[160] Stephen A. Schwarzman and Peter G. Peterson, the founders of Blackstone Group, have the sole power to elect and remove directors. In order to comply with SOX, BX LLC's audit committee is composed entirely of independent directors.[161] BX LLC also has a conflicts committee "charged with reviewing specific matters that our general partner's board of directors believes may involve conflicts of interest."[162]

As a limited partnership, BX also opts out of the fiduciary duties that would have been imposed upon managers of a Delaware corporation, and limits the remedies that would have been available to its shareholders. The BX partnership agreement essentially waives the fiduciary duties of care, loyalty, and good faith as applied to decisions made by the GP in its "sole discretion" or "discretion" or that it deems "necessary or appropriate" or "necessary or advisable."[163] The agreement also indemnifies the GP and its affiliates for civil and criminal proceedings and judgments, absent a court's determination that the GP acted fraudulently or in bad faith.[164] Thus, the GP may be indemnified for negligent, or even grossly negligent acts that damaged BX unitholders. And, it may engage in conflicted transactions under the presumption that such deals are fair and reasonable to BX.[165] The conflicts committee further limits the unitholders' remedies in conflicted transactions: any matters that it approves "will be *conclusively* deemed to be fair and reasonable to us and not a breach by us of any duties we may owe to our common unitholders."[166] For a Delaware corporation, approval by such a committee only would shift the burden of proving unfairness to the plaintiff.[167]

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[160] Id. at 161.
[161] Id. at 161-162.
[162] Id. at 162.
[163] Id. at 183.
[164] Id. at 185.
[165] Id. at 47.
[166] Id. at 162. Emphasis added.
[167] Kahn v. Lynch Communications Systems, 638 A.2d 1110, 1117 (Del. 1994).

BX unitholders have different rights than LPs in a traditional private equity fund or shareholders in a traditional public company. First, as in KPE, BX unitholders part with their full investment upon acquisition of the securities and have no right to withdraw funds under any circumstances, e.g. departure of a "key man." Second, the shareholder franchise is severely constrained. As noted supra, unitholders do not elect the members of BX LLC, which controls the business and affairs of BX, or its board of directors. According to the terms of the BX limited partnership agreement, BX LLC may not be removed as GP absent a two-thirds vote of BX common units and special voting units—more than will be in the hands of the public after the IPO.[168] Most matters pertaining to Blackstone Holdings are not submitted to a vote of its limited partners, BX and the senior managing directors of Blackstone Group; in any case, the latter's ownership stake in Blackstone Holdings would determine the outcome those matters.[169]

BX unitholders' information rights also are strictly limited. Indeed, the reorganization described supra involves the "deconsolidation" of Blackstone entities, designed to remove their assets, liabilities, revenues, expenses and cash flows from BX's consolidated financial statements.[170] As part of the reorganization, LPs of the various Blackstone funds are granted the right to accelerate the liquidation of those funds or the withdrawal of their capital, without cause, by a simple majority vote. Thus, those funds, which are managed by the "operating entities" depicted in Figure 14 no longer are "controlled" by Blackstone Holdings for accounting purposes. According to generally accepted accounting principles (GAAP), they no longer need to be consolidated in BX's financial statements. Deconsolidation also allows BX to recognize an increase in the carrying value of its GP interests to fair value—a gain of more than $900 million.

[168] The Blackstone Group, L.P., FORM S-1 (March 22, 2007) 44.
[169] Id. at 45.
[170] Most of the following is based on id. at 59 & 70-81.

The economic consequences of BX's structure further distinguish it from a either a private equity fund or a public company. First, as Figure 14 illustrates, the senior managing directors and other existing owners of Blackstone Group hold partnership interests directly in Blackstone Holdings, rather than in BX itself. While these units are economically identical to the Blackstone Holdings partnership units received by BX's wholly-owned subsidiaries, their tax attributes are different: unlike those held by BX unitholders ,partnership units held by the senior managing directors are not subject to entity-level taxation,. This and other potential conflicts of interest are the subject of extensive disclosure in the BX prospectus.[171] Second, the potential for dissolution of Blackstone funds by LPs after "deconsolidation" greatly increases the potential volatility of BX returns, particularly during a period of retrenchment. Cascading redemptions, currently only seen in hedge fund failures, could render BX insolvent.[172] Finally, as owners of interests in a partnership, BX unitholders may be subject to U.S. federal income taxation on their share of BX's taxable income, regardless of whether they receive cash dividends.[173]

Certain aspects of the BX IPO have caused observers to question whether it is an appropriate investment for public investors. First, given BX's complex structure, public investors simply may not understand that they are not investing in private equity per se, but in Blackstone Group's management business.[174] Of course, such a criticism may be levied at an IPO undertaken by any complex entity. Second, and more substantively, public investors may be investing in private equity as the industry reaches a peak. In the words of one observer, the BX IPO is "an early indicator of the shift away from cheap debt" and a signal that "the game is

[171] Id. at46 & 179-185
[172] Jenny Anderson, *Hedge Fund With Big Loss Says It Will Close*, N.Y. TIMES (Sept. 30, 2006).
[173] The Blackstone Group, L.P., FORM S-1 (March 22, 2007) 52.
[174] See Michael Kinsley, *Abracadabra for Sale*, TIME (March 22, 2007); and, Jim Jubak, *Blackstone IPO is a Must-Miss*, THESTREET.COM (April 4, 2007).

coming to an end" for private equity.[175] BX's historical financial statements suggest these concerns have some merit: revenues increased more than 100% from 2005 to 2006, Blackstone Group's strongest performance to date.[176] Indeed, by all accounting measures, Blackstone Group is at its historical peak.[177]

Tax considerations enhance these concerns. Because Blackstone Group historically was structured as a set of linked partnerships, its effective tax rate from 2004 to 2006 never exceeded 1.2%. Because three of BX wholly-owned subsidiaries, Blackstone Holdings I GP, II GP, and V GP, will be treated as corporations for U.S. federal income tax purposes, BX unitholders will be taxed at a higher rate.[178] If the reorganization of Blackstone Group had been undertaken on January 1, 2006, the effective tax rate on its taxable income would have been 46% in 2006.[179] Taxed at this rate, its net income would have been $1.4 rather than $2.6 billion. Other tax and regulatory risks, including the possibilities that BX itself might be recharacterized as a corporation by the Internal Revenue Service (IRS) or treated as an "investment company" by the Securities and Exchange Commission (SEC), also contribute to the potential risk to public investors. These risks are discussed in detail infra, at IV.c.iii.

Ultimately, however, the BX IPO offers public investors the opportunity align their interests with private equity principals to a greater extent than has been allowed by BDCs or the European private equity IPOs. Like KPE and AAA, BX is neither truly "private equity" nor a "public company," but something in between. By its structure, the BX IPO creates a "free cash flow" problem and other agency costs traditionally abhorred by private equity. Blackstone Group principals obtain a large source of permanent capital and are not subject to any real

[175] Jubak, supra note 174, 4.
[176] The Blackstone Group, L.P., FORM S-1 (March 22, 2007) 83.
[177] Id. at 82-83.
[178] Id.
[179] Id. at 64.

oversight by public investors, who lack the most basic voting rights. Indeed, Michael Jensen has warned of the agency costs associated with publicly traded private equity vehicles, calling them a "non sequitur both in language and economics."[180] Apollo, which has planned a similar reorganization, will sell interests in its management business in a private placement rather than an IPO.[181] However, what seem like costs from the perspective of private equity may be outweighed by their benefits in the eyes of public investors. In the words of its founders, BX will be a "different kind of public company" with many of the attributes of a successful private equity fund: a long-term perspective, continued focus on fund-level LPs (which will increase returns to BX), use of leverage, and use of equity incentives to align incentives between owners of managers.[182] Whether these hybrids will flourish remains to be seen; however, if the success of FIG's IPO to date is any indication, their prospects are good.[183]

IV. SECONDARY MARKETS IN PRIVATE EQUITY: CURRENT RULES AND REGULATIONS

The section examines the rules and regulations that govern existing secondary markets in private equity, including securities, business organization, and, to a lesser extent, tax law. Part IV.a considers how properly structured acquisition exits and secondary buyouts allow venture capital and private equity funds to precisely calibrate legal and regulatory risk as they exit portfolio company investments. Part IV.b considers legal and contractual restrictions on limited partners' sale of "secondaries," along with the regulation of secondary private equity funds. Finally, Part IV.c analyzes the role played by current rules and regulations, particularly federal securities law, in shaping the private equity vehicles recently offered to public investors.

a. Acquisition Exits and Secondary Buyouts

[180] Michael C. Jensen, *The Case for Private Equity*, Harvard NOM Research Paper No. 07-02 (Feb. 15, 2007) 19.
[181] Andrew Ross Sorkin, *Equity Firm Is Seen Ready to Sell a Stake to Investors*, N.Y. TIMES (April 5, 2007).
[182] The Blackstone Group, L.P., FORM S-1 (March 22, 2007) 7-9.
[183] By mid-April 2007, FIG had returned nearly 60% over its IPO price.

Acquisition exits and secondary buyouts allow financial sponsors to exit investments in their portfolio companies while precisely calibrating their exposure to liability at federal and state law. While transactions involving the sale of securities or their use as acquisition currency will implicate federal securities law, most will avoid all civil liability other than that arising under Section 10(b) and Rule 10b-5 of the 1934 Act.[184] Moreover, the parties may use the devices of business organization and contract law to constrain the scope and substance of federal and state law liability. The federal securities and state law aspects of acquisition exits and secondary buyouts are essentially identical.[185]

i. Securities Law Aspects of Acquisition Exits and Secondary Buyouts

Generally, parties to an acquisition exit or a secondary buyout will not be required to comply with the 1933 Act, even if the transaction takes the form of a sale of securities. Assuming the selling private equity fund's interest in its portfolio company takes the form of restricted securities, their resale usually will be exempted by Section 4(1) of the 1933 Act from the registration requirements of Section 5.[186] Any risk that the seller may be characterized as an "underwriter" ineligible for the Section 4(1) exemption can be avoided by structuring the sale as a private placement, [187] taking advantage of the so-called Section 4 (1 1/2) exemption.[188]

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[184] 15 U.S.C.A. § 78j(b); and, 17 C.F.R. § 240.10b-5. Issuers also will be subject to similar liability under Section 17(a) of the Securities Act of 1933 in suits that may be brought only by the SEC. 15 U.S.CA. §77q(a).

[185] Secondary buyouts are more likely also to involve the purchaser's negotiation of a credit facility (leverage), a matter not material to our discussion.

[186] 15 U.S.C.A. § 77d(1) & 77e.

[187] Because a private equity fund may be considered an "affiliate" (controller) of its portfolio company for the purposes of Rule 144, it may be ineligible for the two-year holding period, unlimited resale safe harbor provided by Rule 144(k). 17 C.F.R. § 230.144. While a three-year holding period is "well-nigh conclusive" evidence of a lack of distributive intent, "affiliates" seeking to avoid litigation risk will structure their resales as private placements. See J. William Hicks, 7A EXEMPTED TRANS. UNDER SECURITIES ACT 1933 (ed. Feb. 2007) §§ 9:119-123.

[188] The Section 4 (1 1/2) exemption is a hybrid exemption based upon Sections 4(1), the ordinary trading exemption, and 4(2), the private placement exemption. It is discussed in greater detail in connection with the sale of "secondaries," infra.

Neither the selling private equity fund nor its advisors will be subject to the powerful civil liability provisions of the 1933 Act. Because the private placement of portfolio company securities will involve neither registration pursuant to Section 5 nor the registration statement described in Section 6, the seller will avoid the strict liability and rescissionary remedies of Sections 11 and 12(a)(1).[189] Moreover, following the Supreme Court's holding in Gustafson v. Alloyd Co. that private placements do not involve a statutory "prospectus," the seller also will escape liability for fraudulent communications under Section 12(a)(2).[190] Thus, the strongest civil liability provisions of the federal securities law will not apply to the selling private equity fund or its portfolio company in an acquisition exit or a secondary buyout. For the same reasons, they also will not apply to the seller's advisors on the transaction.

The purchaser will need to comply with the 1933 Act only if it offers securities to the seller in the transaction. Because acquisition exits and secondary buyouts represent an exit opportunity for the seller the consideration rarely will include securities. Even if the purchaser were to offer securities to the seller, it could avoid the registration requirements of Section 5 and the civil liability provisions of Sections 11 and 12 by structuring the sale as a private placement.

Parties to an acquisition exit or a secondary buyout will be subject to the provisions of the 1934 Act. A merger taking the form of a sale of stock involves the "sale" of a "security" for the purposes of the 1934 Act. In SEC v. National Securities, Inc.,[191] the Supreme Court held that a merger structured as a sale of the target company's stock involves a "purchase" and a "sale" for

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[189] 15 U.S.C.A. §§ 77e, 77f, 77k, & 77*l*(a)(1).
[190] 513 U.S. 561, 576 (1995). See also, Dietrich v. Bauer, 1996 WL 709572, *6 (S.D.N.Y. 1996) (oral communications made in private placement do not relate to statutory prospectus, and are not actionable under §12(a)(2) of 1933 Act). While neither Section 4(2) nor Regulation D exempts private placements from the antifraud provisions of the 1933 Act, Gustafson and its progeny effectively limit the application of such provisions to public offerings.
[191] 393 U.S. 453, 467 (1969).

the purposes of Sections 3(13) and (14) of the 1934 Act.[192] Moreover, since the Court rejected the "sale of business" doctrine in Landreth Timber Co. v. Landreth[193] and Gould v. Ruefenacht,[194] any security or stock sold in a merger must be considered a "security" within the meaning of Section 3(10) of the Act.[195] Thus, though a transaction involving the transfer of a portfolio company from a private equity firm to a financial or strategic buyer bears little resemblance to the ordinary trading of securities (or even a tender offer for a public company), it nevertheless will be subject to Section 10(b) and Rule 10b-5.[196] The purchaser's use of securities as an acquisition currency also will be subject to Section 10(b) and Rule 10b-5, whether public or restricted.[197] These provisions are mandatory; parties may not contract around them.[198]

All parties to an acquisition exit or a secondary buyout may limit their Rule 10b-5 liability by contract. Sophisticated parties generally will include a merger (or, "integration") clause in the stock purchase agreement consummating the sale, wherein one or more parties will disclaim reliance upon any representations not made therein (i.e., written and oral representations made during due diligence). In all cases, such a clause will be considered evidence that the purchaser did not rely upon the seller's extra-contractual representations, and may provide a basis for summary judgment when not rebutted.[199] When the parties are sophisticated, such a

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[192] 15 U.S.C.A. § 78c(13) & (14).
[193] 471 U.S. 681, 697 (1985).
[194] 471 U.S. 701, 705 (1985).
[195] 15 U.S.C.A. § 78c(10). See, generally, Simon M. Lorne & Joy Marlene Bryan, ACQUISITIONS AND MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS (ed. Nov. 2006) § 3.30.
[196] 15 U.S.C.A. § 78j(b); and, 17 C.F.R. § 240.10b-5.
[197] See, e.g., Cohen v. Northwestern Growth Corp., 385 F.Supp.2d 935, 949-950 (D.S.D. 2005) (private company issuer of restricted securities in acquisition may be subject to Rule 10b-5 liability to selling stockholders for unrealized promise to take combined entity public).
[198] Section 29(a) of the 1934 Act prohibits waiver of any substantive obligation imposed by the 1934 Act, or any rule promulgated thereunder. 15 U.S.C.A. § 78cc(a).
[199] AES Corp. v. Dow Chemical Co., 325 F.3d 174, 180 (3d Cir. 2003), cert. denied.

clause will not violate Section 29 of the 1934 Act, and will be enforced to preclude a Rule 10b-5 claim based on any extracontractual representations.[200]

"Higher" entities affiliated with the selling parties may limit their 1934 Act liability by careful observance of the formalities of business organization law. When making its initial investment in a portfolio company, a private equity fund often will create a separate, subsidiary entity to act as an investment vehicle. For example, a fund managed by Providence Equity Partners, Inc., established two entity layers between itself and one of its portfolio companies, F&W Publications, Inc. The intermediate entities owned the stock of the portfolio company, and signed the stock purchase agreement selling the company.[201] Even in the absence of such a vehicle, the fund investing in the portfolio company itself will be a subsidiary entity of the private equity firm. For example, Kohlberg Kravis Roberts & Co. L.P. acted as general partner of KKR Associates, L.P., which in turn served as general partner of a number of funds, such as KKR Partners II L.P., that invested directly in portfolio companies.[202] Absent disregard of the formalities of business organization law, the higher private equity entities will be insulated from liability for their subsidiaries' fraud.[203] However, "intertwined management and financial structures" and/or active involvement of higher entity principals in the sale of the portfolio company may subject the higher entity to liability for fraud committed in the sale process.[204]

In order to properly plead a Rule 10b-5 claim against a financial sponsor, the plaintiff must allege with particularity that one or more of its principals was the "speaker" of fraudulent

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[200] Dresner v. Utility.com, Inc., 371 F.Supp.2d 476, 492 (S.D.N.Y. 2005); Harsco Corp. v. Segui, 91 F.3d 337, 343 (2d Cir. 1996); cf., Rogen v. Ilikon Corp., 361 F.2d 260, 268 (1st Cir. 1966) (merger clause signed by individual shareholder may not enforced).
[201] See, ABRY Partners V, L.P. v. F&W Acquisition LLC, 891 A.2d 1032, (Del. Ch. 2006), discussed at length, infra.
[202] See, In re Primedia Inc. Derivative Litigation, 910 A.2d 248, 251 (Del. Ch. 2006).
[203] Polycast Technology Corp. v. Uniroyal, Inc., 1988 WL 96586, *5 (S.D.N.Y. 1988) ("Polycast I").
[204] Polycast Technology Corp. v. Uniroyal, Inc., 728 F.Supp. 926, 936 (S.D.N.Y. 1988) ("Polycast II").

misrepresentations or omissions, and that the principal(s) had the requisite scienter.[205] Obviously, a higher entity will be liable if it is signatory to the stock purchase agreement (e.g., as selling shareholder).[206] Without a signature, however, "bare allegation of involvement" in the sale will not satisfy the particularity requirement.[207] Furthermore, the "group pleading" doctrine for Section 10(b) liability will reach higher entity principals only when they are insiders involved in the management of the portfolio company. If higher entity principals do not "act like corporate insiders," the plaintiff must allege that he actually made the alleged misrepresentations or omissions.[208] If the principal were a non-insider, she would be considered an "outside director" under Section 21D of the 1934 Act, requiring the plaintiff to allege her "actual knowledge" of the misrepresentations or omissions.[209] Even if she were an insider, neither "insider status" nor "access to data" is enough to raise an inference of scienter.[210] At a minimum, the plaintiff must plead with particularity "reckless behavior" by the higher entity principal, giving rise to an inference of scienter.[211]

A higher private equity entity may be liable as a "controlling person" when its portfolio company has committed fraud in the sale.[212] A "higher" private equity entity may not always be a controlling person; however, interlocking personal relationships or a pattern of financial transactions, as well as the actual exercise of control, may allow the plaintiff to characterize the

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[205] For a quite useful discussion of "higher" entity liability, including both direct and controlling person liability, see, Carl E. Metzger & Inez H. Friedman-Boyce, *Defending Venture Capital Firms in Securities Litigation*, 39 REV. OF SECURITIES & COMMODITIES REG. 8 (Apr. 19, 2006) 63-78.
[206] JHW Greentree Capital, L.P. v. Whittier Trust Co., 2005 WL 3008452, *6 (S.D.N.Y. 2005); see also, In re JWP Inc. Securities Litigation, 928 F.Supp. 1239, 1256 (S.D.N.Y. 1996) (director signatories of Form 10-K made misrepresentations in document).
[207] Polycast I, at *5.
[208] Dresner v. Utility.com, Inc., at 494.
[209] 15 U.S.C.A. § 78u-4(f)(10).
[210] Polycast I, at *6; In re Apple Computer Inc. Securities Litigation, 243 F.Supp.2d 1012, 1027 (N.D.Cal.2002).
[211] Sanders v. John Nuveen & Co., Inc., 554 F.2d 790, 793-794 (7th Cir. 1977), cert. denied.
[212] 15 U.S.C.A. § 78t.

higher entity as a controlling person.[213] To proceed under Section 20, the plaintiff need not allege the scienter of the controlling person, only its control.[214] The controller bears the burden of demonstrating his "good faith" and failure to "directly or indirectly induce" the fraud as an affirmative defense.[215] However, the plaintiff nevertheless must allege—and ultimately prove—its underlying Rule 10b-5 claim against the portfolio company, including scienter.[216] If both underlying and controlling person liability are found, the higher private equity entity will be liable jointly and severally for the fraud of its portfolio company.[217]

Properly structured acquisition exits and secondary buyouts will insulate venture capital and private equity investors from the most stringent and costly regulatory and litigation burdens imposed by the federal securities laws. Unless the deal consideration requires the purchaser to issue stock, all parties to the transaction (including advisors) will be exempt from both the registration and civil liability provisions of the 1933 Act. While the portfolio company and the selling private equity firm will remain subject to civil liability under Section 10(b) and Rule 10b-5 of the 1934 Act, these parties may constrain potential liability by contractual and corporate law devices. The inclusion of a merger clause in the stock purchase agreement will limit the subject matter of the purchaser's reliance to the agreement itself, requiring it to prove fraud within the four corners. Establishment of an intermediary entity to act as selling shareholder, along with careful observation of corporate formalities, will provide a further liability shield for higher entities. Distance from the sale process also will provide a basis for the affirmative defenses

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[213] See, e.g., In re Williams Securities Litigation, 339 F.Supp.2d 1206, 1237-1238 (N.D.Okla. 2003) (parent-subsidiary).
[214] Polycast I, at *7.
[215] Id.; see also, Metge v. Baehler, 762 F.2d 621, 631 (8th Cir. 1985); G.A. Thompson, Inc. v. Partridge, 636 F.2D 945, 958 (5th Cir. 1981); Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir. 1980) (control person must at least show lack of negligence), cert. denied.
[216] Dresner v. Utility.com, Inc., at 491.
[217] 15 U.S.C.A. § 78t(a).

against controlling person liability. Thus, parties to acquisition exits and secondary buyouts effectively may opt out of most of federal securities law.

ii. State Law Aspects of Acquisition Exits and Secondary Buyouts

Parties to an acquisition exit or secondary buyout may not opt out of common law and statutory liability for intentional fraud; however, they may contractually eliminate civil liability for almost everything else. Most courts hold disclaimers and restrictions limiting claims based on intentional misrepresentations void as against public policy, and will not enforce them.[218] However, a recent decision by Vice Chancellor Strine of the Delaware Court of Chancery, ABRY Partners V, L.P. v. F&W Acquisition LLC ("ABRY Partners"),[219] underscores the broad contractual latitude that Delaware courts will give to sophisticated parties to a merger agreement. While other state courts may impose considerable restraints upon freedom of contract, Delaware allows financial sponsors to precisely allocate the risk arising from a private sale. In effect, Delaware provides parties to an acquisition exit or secondary buyout with a blueprint for a transactional structure that will allow them to opt out of most state law liability.

The dispute in ABRY Partners arose from a secondary buyout gone sour. In March 2005, Providence Equity Partners ("Providence"), a private equity firm specializing in media and publishing, announced its intent to auction F&W Publications, Inc. ("F&W"), one of its portfolio companies, and retained Credit Suisse First Boston as selling agent.[220] For three months in the spring and early summer, ABRY Partners ("ABRY"), a smaller private equity firm, negotiated the purchase of all of the stock of F&W for around $500 million. The parties signed a stock purchase agreement in early June, and closed the deal in August. As is common in private equity

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[218] See, e.g., Turkish v. Kasenetz, 27 F.3d 23, 27-28 (2d Cir. 1994).
[219] ABRY Partners V, L.P. v. F&W Acquisition LLC, 891 A.2d 1032, (Del. Ch. 2006) ("ABRY Partners").
[220] ABRY Partners, Plaintiff's Complaint, 2005 WL 3935251, *1-16 (Del.Ch. Nov. 3, 2005).

deals in the publishing industry, ABRY based its valuation of F&W on the company's prior year earnings before interest, taxes, depreciation and amortization ("EBITDA").[221]

By November, ABRY had come to regret its bargain and filed suit, seeking rescission on the grounds of fraud and fraudulent inducement by F&W and Providence. ABRY alleged in its complaint that F&W employees engaged in a number of fraudulent practices—e.g., "channel stuffing" and "back-starting"—intended to manipulate the company's financial statements, artificially inflating EBITDA by more than 20%.[222] ABRY also claimed various misrepresentations by F&W and Providence during negotiations.[223] However, as Providence noted in its reply brief, the stock purchase agreement contained both a merger clause and an exclusive remedy provision.[224] By agreeing to the former, Providence argued, ABRY disclaimed reliance upon representations not included within the four corners of the agreement. By agreeing to the latter, ABRY limited its remedy for all claims —even intentional, fraudulent misrepresentations—to four percent of the purchase price, or $20 million. Based upon these provisions, Providence moved to dismiss ABRY's rescission claim.

Vice Chancellor Strine refused to dismiss ABRY's rescission claim; however, he held that in order to rescind the agreement ABRY must prove that F&W or Providence intentionally misrepresented facts included in the agreement and its schedules (e.g., the financial statements), and that Providence had knowledge of these misrepresentations when it signed the agreement.[225] If ABRY could not prove that "the Seller [i.e., Providence] knew that the misrepresentation was false and either communicated it to the Buyer directly or knew that the Company had," it would

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[221] ABRY Partners, Plaintiff's Amended Complaint, 2005 WL 3935250, *8 (Del.Ch. Dec. 2, 2005).
[222] Id. at *18-21.
[223] Id. at *12-13 & 24.
[224] ABRY Partners, Defendants' Reply Brief in Support of their Motion to Dismiss the Amended Complaint, 2005 WL 372495, *2-9 & 19-27 (Del.Ch. Jan. 5, 2006).
[225] ABRY Partners, at 1064.

be limited to indemnification pursuant to the exclusive remedy clause.[226] Thus, while affirming the common law tradition that contracts purporting to insulate a party from liability for its own fraud are void as against public policy, the Vice Chancellor Strine also strictly limited its reach.

The decision in ABRY Partners provides a blueprint for selling private equity funds to limit their liability at contract and tort in an acquisition exit or secondary buyout. When a financial sponsor does not actively manage the daily business and affairs of its portfolio company, it will not be considered to have "control" of that company—even if does control the sale of that company due to its economic ownership. In ABRY Partners, the Vice Chancellor gave effect to the distinction between financial sponsor (the "Seller," i.e., Providence) and portfolio company (the "Company," i.e. F&W) set forth in the stock purchase agreement. The Vice Chancellor noted that F&W alone made the representations and warranties regarding the accuracy of the financial statements in the stock purchase agreement. "If this was all the Stock Purchase Agreement said," he concluded, "the contract's plain terms would most logically be read to preclude any suit by the Buyer against the Seller for all representations and warranties made by the Company."[227] Thus, when a private equity fund leaves day-to-day control of its portfolio companies to their managers, as is usually the case, it may escape liability for management's fraud in the sale process by refusing to take responsibility for their representations and warranties. Unfortunately for Providence, it did take responsibility for the accuracy of F&W's representations and warranties.[228] In late May 2006, the parties reached a settlement in which Providence agreed to make an undisclosed investment in F&W alongside ABRY.[229]

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[226] Id.
[227] Id. at 1043.
[228] Id.
[229] Marrecca Fiore, *ABRY Settles Suit over F+W Sale*, FOLIO MAGAZINE (June 30, 2006).

Outside Delaware, state courts have not provided a blueprint for the allocation of risk arising in acquisition exits and secondary buyouts. Absent fraud, most courts will respect negotiated restrictions and disclaimers of liability in the context of acquisition exits and secondary buyouts;[230] however, many will construe such provisions very narrowly. For example, in a case quite similar to ABRY Partners, a New York Superior Court narrowly interpreted the arbitration clause in the parties' agreement, holding that claims arising from alleged breaches of representations and warranties could be brought as indemnification claims in state court.[231] In all states, enforcement of a merger clause will depend on the sophistication and bargaining power of the parties to the agreement.[232]

In some states, the seller in an acquisition exit or secondary buyout may be found to have a "relationship of trust and confidence" with the buyer, subjecting it to tort liability for fraudulent concealment or negligent misrepresentation. For example, in Polycast I, a federal court in the Southern District of New York refused to dismiss a claim for negligent misrepresentation arising from a private equity fund's sale of a subsidiary of one of its portfolio companies, holding that the existence of such a relationship was a matter of fact for the jury under New York law.[233] However, in some states (such as Georgia), a buyer's access to diligence documents and discovery of concealed information will preclude a claim for fraudulent concealment or negligent

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[230] See, e.g., Lego v. Stratos International, Inc., 2005 WL 388613, at *5 (N.D.Cal. 2005).
[231] Lincoln Snacks Holding Co., Inc. v. Brynwood Partners III L.P., 803 N.Y.S.2d 19, 2005 WL 1845665, *5-7 (N.Y.Sup. 2005). In February 2004, Lincoln Snacks Holding Co., Inc, an investment vehicle owned by Willis Stein & Partners, purchased Lincoln Snacks, Inc., from Brynwood Partners for about $99 million cash. In November, Willis Stein filed suit, alleging that Brynwood knowingly misrepresented the financial performance of its portfolio company and engaged in channel-stuffing during the sale process. Willis Stein sought $23 million in damages. See, K.M., *Willis Stein, Brynwood Spar Over Lincoln Snack Sale*, BUYOUTS (Jan. 3, 2005) 3-4; K.M., *Brynwood to Willis Stein: Now You Got Served*, BUYOUTS (Jan. 17, 2005) 6-7; K.M., *Brynwood—Willis Stein Struggle Marches On,* BUYOUTS (Aug. 1, 2005) 22.
[232] Cohen v. Northwestern Growth Corp., at 961 (D.S.D. 2005) (under S.D. law, merger clause in a non-negotiable agreement will not be enforced to bar claim for fraudulent inducement).
[233] Polycast I, at 269-270.

misrepresentation, as there can be no reliance or causation in such a case.[234] It is difficult to imagine the Delaware Court of Chancery finding a "relationship of trust and confidence" between sophisticated parties to a negotiated merger agreement.[235]

The broad freedom of contract preserved by Delaware courts provides parties to an acquisition exit or secondary buyout with the ability to allocate the associated risk with near precision. Using the tools provided by business organization law and contract, sophisticated parties may strictly limit both the subject and scope of their liabilities under federal securities law and state contract and tort law. "Higher" entities—venture capital and private equity funds and their principals—may be shielded altogether from all but their own intentional fraud, provided they are not actively involved in the management of the company for sale. Moreover, in stark contrast to the situation pertaining in federal securities and state derivative litigation involving public companies, parties' incentives to litigate generally are aligned with their economic stake in the transaction. These factors enable and encourage parties to acquisition exits and secondary buyouts to estimate and allocate the expected costs and benefits of the deal with precision. This, in combination with the reluctance of private equity funds to "police" each other in the courts, has made litigation arising from such transactions remarkably rare.

b. <u>"Secondaries" and Secondary Funds</u>

Secondary resales of LP interests in venture capital and private equity funds allow original holders to exit particular investments before the termination and winding up of the fund. Such transactions also allow the purchasers of secondaries to enter funds that may be closed to new investors, as part of either absolute return or portfolio investment strategies. Due to permissive state partnership law, resales of LP interests generally are subject to contractual

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[234] <u>Tampa Bay Financial, Inc. v. Nordeen</u>, 612 S.E.2d 856, 859 (Ga.App. 2005).
[235] <u>ABRY Partners</u>, at 1065 n. 86.

restrictions on transferability. The extent of such restrictions will vary from one fund to the next. LP interests also will be considered "securities" for the purposes of federal securities law, and will be subject to the registration requirements and transaction exemptions of the 1933 Act. Because most venture capital and private equity limited partnership interests are offered to investors through private placements, federal securities law restricts their resale and, therefore, the liquidity of private equity investing. Moreover, because the transaction exemptions available for primary private placements differ from those applied to secondary resales, some private equity investors will be able to access the secondary market with ease while others will be locked into, or out of, primary investments. Nevertheless, appropriate transactional planning will allow all parties to engage in secondary resales of LP interests without registration, subject to civil liability arising under Section 10(b) and Rule 10b-5 of the 1934 Act.[236]

In the absence of an exemption, secondary funds are subject to entity-level federal regulation under the 1940 Act.[237] Of course, like most venture capital and private equity funds, secondary funds are structured to avoid registration. However, unlike its "primary" cousins, even an unregistered secondary fund will be subject to restrictions on its investment activities.

i. State Law Aspects of Secondary Resales

State law allows parties to a limited partnership to place practically unlimited restrictions on the transferability of LP interests. As J. William Hicks notes, "restrictions on the transferability of securities are regulated under state law within a permissive framework."[238] The Uniform Limited Partnership Act (ULPA), adopted by sixteen states, requires limits on withdrawal and assignment to be set forth in the certificate of limited partnership filed with the

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[236] 15 U.S.C.A. § 78j(b); <u>and</u>, 17 C.F.R. § 240.10b-5. As with secondary buyouts, secondary resales also are subject to antifraud actions brought by the SEC pursuant to Section 17(a) of the 1933 Act. 15 U.S.C.A. § 77q(a).
[237] 15 U.S.C. § 80a-1 et seq.
[238] J. William Hicks, RESALES OF RESTRICTED SECURITIES (ed. Jan. 2007) §1:1.

state.[239] The Revised Uniform Limited Partnership Act (RULPA), adopted by thirty-four states, permits limited partnership agreements to restrict both withdrawal and assignment, without reference to the certificate.[240] In Delaware, which has adopted RULPA, an LP may be locked in for the life of the partnership: the partnership agreement may provide that an LP may not withdraw or assign his interest prior to dissolution and winding up.[241] Notwithstanding certain restrictions providing for good faith and access to information, the policy of Delaware law is "to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements."[242]

As noted supra, in III.b.i, venture capital and private equity funds and their investors take advantage of their contractual liberty to limit the transferability of limited partnership interests.[243] Partnership agreements typically require LPs seeking to sell or assign their interests in the fund to comply with confidentiality provisions (e.g., having prospective purchasers sign a non-disclosure agreement before receipt of information), and to obtain the GP's consent to the sale. Sometimes, the agreement will require approval of the sale by a certain percentage of the other LPs, and/or grant the other LPs a right of first refusal. All agreements will prohibit sales or assignments that may create securities or tax problems for the fund. Often, this will require the seller to establish that the transaction meets one of the exemptions from registration under federal securities law.

Certain parties to secondary resales, like public pension funds, may be required to disclose the transactions to the public. In November 2002, the San Francisco Superior Court held that the California Open Records Act requires CalPERS, the largest public pension fund in

[239] Unif. Litd. Partnership Act §2(1)(a)(X). See, Hicks, RESALES, supra note 238, § 1.1
[240] Rev. Unif. Ltd. Partnership Act §§603, 702.
[241] 17 Del. C. §§ 603. 702.
[242] 15 Del. C. § 103(c).
[243] This paragraph draws upon Levin, supra note 19, ¶¶ 1012-1012.3.

the United States, to disclose investments in venture capital and private equity funds to the public, along with data on fees and internal rates of return.[244] Many state pension funds and some other public institutions, such as the University of California, have followed suit.[245] Thus, for example, the 2004 Annual Report of the Treasurer of the State of Connecticut discloses the secondary resale of four limited partnership investments in Triumph Capital Group by the Connecticut Retirement Plans and Trust Funds.[246] These disclosure requirements may run afoul of confidentiality provisions in some limited partnership agreements.

ii. Federal Securities Law Aspects of Secondary Resales

Section 4(2) of the 1933 Act allows the GPs of a venture capital or private equity fund to avoid the registration and civil liability regime of the 1933 Act by offering limited partnership interests to sophisticated investors in a private placement.[247] An offering to sophisticated investors—"those who are able to fend for themselves"—is a transaction "not involving any public offering."[248] Regulation D elaborates upon the statutory exemption, providing a safe harbor for private offerings of unlimited amounts in Rule 506.[249] Privately placed LP interests are restricted securities; original holders wishing to resell these securities must either register them pursuant to the 1933 Act, or risk civil liability for its violation. Unfortunately, the protections of Section 4(2) and Regulation D are available only to an "issuer." However, two rules promulgated under the 1933 Act, Rules 144 and 144A, as well as a "common law" exemption, "Section 4(1 1/2)," permit properly structured secondary resales to escape all liability under federal securities law save that of Section 10(b) and Rule 10b-5.

[244] Matt Marshall, *Public Pension Fund Releases Performance Data*, SAN JOSE MERCURY NEWS (Dec. 21, 2002). See, Susan Chaplinsky & Susan Perry, *Calpers vs. Mercury News: Disclosure Comes to Private Equity* (Darden Case No.: UVA-F-1438-SSRN), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=567525.
[245] Dan Primack, *False Alarm?* VENTURE CAPITAL JOURNAL (Sept. 1, 2003).
[246] State of Connecticut, ANNUAL REPORT OF THE TREASURER (2004) F-27.
[247] 15 U.S.C.A § 77d(2).
[248] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).
[249] 17 C.F.R. § 230.501-508.

Section 4(1) of the 1933 Act provides what is known as the "ordinary trading" exemption to registration: a security may be resold without registration "by any person other than an issuer, underwriter or dealer."[250] However, this broad exemption is swallowed by the 1933 Act's expansive of "underwriter." The seller will be considered an "underwriter" if he is determined to have purchased the securities from the issuer "with a view to" or "in connection with" their distribution.[251] The original purchaser's holding period is the crucial factor in the "underwriter" determination.[252] If determined to be an "underwriter," the seller will be subject to the registration requirements and civil liability provisions of the 1933 Act. Because the restricted securities have not been registered, their "distribution" by an "underwriter" will be in violation of Section 5 of the 1933 Act, subjecting the LP to the risk of rescission and/or disgorgement.

Rule 144 establishes a safe harbor for the resale of restricted securities; however, its usefulness is limited by its lengthy holding period requirements. The Rule provides that any seller of restricted securities who complies with all of its provisions "shall be deemed not to be engaged in a distribution of such securities and therefore not an underwriter thereof."[253] The terms and conditions of the safe harbor differ depending on whether the seller is determined to be an "affiliate" of the issuer of the securities. In the usual case, an LP to a venture capital or private equity fund will not be an "affiliate" of the fund.[254] After a one-year holding period, a non-affiliated LP would be able to resell freely a "trickle" of his fund interests not to exceed one percent of the number of such securities outstanding.[255] After two years, a non-affiliated LP

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[250] 15 U.S.C.A § 77d(1).
[251] 15 U.S.C.A § 77b(11).
[252] A three-year holding period is "well-nigh conclusive" evidence that the seller is not an underwriter. See, Hicks, 7A EXEMPTED TRANS., supra note 187, §§ 9:119-123.
[253] 17 C.F.R. § 230.144, Preliminary Note. See also, Notice of Adoption of Rule 144, Securities Act Release No. 33-5223, Fed. Sec. L. Rep. (CCH) ¶ 78,487 (Jan. 11, 1972).
[254] An "affiliate" of an issuer is "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." 17 C.F.R. § 230.144(a)(1).
[255] 17 C.F.R. § 230.144(d)(1) & (e)(2).

would be able to resell his fund interests without limitation.[256] If the seller were an "affiliate," he would remain subject to the "trickle" requirement in perpetuity.[257] The securities would be unrestricted in the purchaser's hands, save any limits imposed by the partnership agreement.

If an LP does not meet the terms and conditions of Rule 144—e.g., he has not held the securities for the applicable holding period—he nevertheless may resell restricted securities without registration according to the terms of the "Section 4 (1 1/2)" exemption. The crucial difference is that Rule 144 allows the holder to resell restricted securities to the public, while "Section 4 (1 1/2)" requires him to conduct a second private placement. As its name indicates, "Section 4(1 1/2)" is an amalgam of Sections 4(1) and 4(2). It allows the holder of restricted securities to resell those securities without being considered a statutory "underwriter" if the resale is private placement that complies with the terms of Section 4(2), and/or the safe harbor of Regulation D.[258] Thus, even if the LP's fund interests have not "come to rest," the resale will be exempt from registration if the issuer did not make a public offering, and the purchaser would have qualified as a sophisticated investor for the original private placement.[259] While "Section 4 (1 1/2)" has not been codified as an exemption to the 1933 Act, the SEC has endorsed it as being "clearly within [the] intended purpose" of the 1933 Act.[260]

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[256] 17 C.F.R. § 230.144(k).
[257] 17 C.F.R. § 230.144(d)(1) & (e)(1)
[258] 15 U.S.C.A § 77d(1); 17 C.F.R. § 230.501-508. See, Hicks, 7A EXEMPTED TRANS., supra note 187, § 9:119. See also Hicks, RESALES OF RESTRICTED SECURITIES § 6:36; and, Report to the Committee on Federal Regulation of Securities of the ABA from the Study Group on Section "4 (1 1/2)" of the Subcommittee on 1933 Act—General, *The Section '4(1 1/2)' Phenomenon: Private Resales of Restricted Securities*, 34 BUS. LAW. 1961 (1979).
[259] Hicks, 7A EXEMPTED TRANS., supra note 187, § 9:119
[260] Id., § 9:121. Note that parties to a secondary resale must take care to structure the transaction properly: "persons who offer or sell restricted securities without complying with Rule 144 are hereby put on notice by the Commission that […] they will have a substantial burden of proof in establishing that an exemption from registration is available for such offers or sales and that suchpersons and the brokers and other persons who participate in the transactions do so at their risk." Securities Act Release No. 33-5223, Fed. Sec. L. Rep. (CCH) ¶ 78,487, at 81,050 (Jan. 11, 1972).

Rule 144A establishes a private secondary market in which unregistered securities may be traded freely.[261] However, access to this market is available only to the largest institutional investors, "qualified institutional buyers" (QIBs) with at least $100 million invested in securities and an audited net worth in excess of $25 million (lower capital requirements are applied to dealers).[262] While LP interests in venture capital or private equity funds are eligible securities for the purposes of Rule 144A,[263] most securities traded on this market are debt securities issued by domestic and foreign issuers and equity securities of foreign issuers not listed on U.S. public markets.[264] Indeed, although the architects of Rule 144A envisioned it as "the first step toward achieving a more liquid and efficient institutional resale market for unregistered securities,"[265] principally through the PORTAL (Private Offering, Resale and Trading Through Automated Linkages) exchange system, the market most commonly is used for the primary private placement of eligible securities.[266]

As noted supra in III.b.i, a number of parties have attempted to create liquid secondary markets in restricted securities. NYPPE is the organizer of the leading secondary market in venture capital and private equity limited partnerships. In light of SEC No-Action letters approving the creation of internet-based networks for the private placement of restricted securities—and, of course, the continued existence of markets like NYPPE—there seems to be no principle of federal securities law that precludes free trading of "secondaries" in such a

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[261] 17 C.F.R. § 230.144A.
[262] 17 C.F.R. § 230.144A(d)(1).
[263] 17 C.F.R. § 230.144A(d)(3).
[264] Harold S. Bloomenthal, 1 SEC. LAW HANDBOOK § 10:18. See also, Hal S. Scott, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION (15th ed. 2007) Ch. 2.E.
[265] Securities Act Release No. 33-6862, 1990 WL 311657 (Apr. 23, 1990), Fed. Sec. L. Rep. (CCH) ¶ 80,637, at 80,639.
[266] Scott, supra note 264, Ch. 2.E.1.d

market, provided appropriate precautions are taken to restrict trading to accredited investors.[267] Regulation of the market itself ultimately would depend upon its organization; however, the SEC likely would regulate it as an alternative trading system rather than as an exchange.[268] Recently, Nasdaq has announced the launch of its Portal Trading System, an electronic trading platform that will quote prices in Rule 144A securities for brokers and institutions.[269] Of course, this new market, unlike NYPPE, will be open only to QIBs.

Properly structured sales of "secondaries," whether via Rules 144 or 144A, or "Section 4(1 1/2)," are subject to private securities actions only under Section 10(b) and Rule 10b-5 of the 1934 Act. As in secondary buyouts, contract and business organization law—merger clauses and entity shielding—may be used to avoid 10b-5 liability. Such transactions also offer the possibility of greater speed, efficiency, and discretion than trading in public equity. However, the need to structure resales to avoid registration and the opacity of the market in "secondaries" combine to raise transaction costs and lower liquidity for investors, and ultimately increase the cost of capital to venture capital and private equity funds.

iii. Securities Law Restrictions on Secondary Funds

Like most venture capital and private equity funds, secondary funds are structured to avoid registration under the 1940 Act (see discussion, supra, in III.b.ii). A secondary fund will

[267] As John C. Coffee, Jr., writes, "logic suggests that [an electronic] matching service might also seek to facilitate secondary transactions (i.e., private resales) among secondary investors. *Brave New World? The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1221 (1997). See, IPOnet, SEC No-Action Letter,1996 WL 431821 (July 26, 1996); Angel Capital Electronic Network, SEC No-Action Letter,1996 WL 636094 (Oct. 25, 1996). See also, Niphix Investments, Inc., SEC No-Action Letter, 1997 WL 209335 (Apr. 18, 1997) (approving electronic network for secondary trading in Regulation A exempt securities).

[268] "Alternative trading system" (ATS) refers to "automated systems that centralize, display, match, cross, or otherwise execute trading interest, but that are not registered with the Commission as national securities exchanges or operated by a regulated securities association." Exchange Act Release No. 34-38672, 1997 WL 292193 (May 25, 1997), 62 Fed. Reg. 30485, at 30485. An ATS is regulated as a securities exchange, but is not required to supervise its members. The SEC granted NYPPE ATS status in 2000, but NYPPE has continued to submit to regulation as a NASD broker-dealer. On exchange, broker-dealer, and ATS regulation, see generally, Ruben Lee, WHAT IS AN EXCHANGE? THE AUTOMATION, MANAGEMENT, AND REGULATION OF FINANCIAL MARKETS (ed. 2002), Ch. 12.

[269] Shanny Basar, *Nasdaq Opens Portal to Private Market Growth*, FINANCIAL TIMES (March 1, 2007).

be an "investment company" for the purposes of the 1940 Act.[270] Like "primary" funds, a secondary fund generally will avail itself of the private investment fund or qualified purchaser exemptions set forth in Sections 3(c)(1) and 3(c)(7) of the Act, respectively.[271] Thus, the secondary fund will be required to restrict itself to 100 or fewer investors, 65 of whom must be accredited,[272] or to allow only "qualified purchasers" to invest in the fund.[273]

However, the statutory "look-through" rules applied to these very exemptions will constrain a secondary fund's ability to buy and sell secondaries. If a secondary fund comes to own more than a 10% voting interest in a "lower" venture capital or private equity fund exempt from registration pursuant to Section 3(c)(1), owners of the secondary fund will be deemed owners of the underlying fund.[274] Often, this will result in the underlying § 3(c)(1) fund being deemed to have more than 100 beneficial owners, requiring it to register under the 1940 Act. Generally, of course, contractual restrictions on LP interests in the underlying § 3(c)(1) fund will prohibit transfer to the secondary fund.

Contractual restrictions also generally will preclude secondary resales of interests in a "lower" § 3(c)(7) fund in the unlikely event that the secondary fund purchasing the securities is not a "qualified purchaser." The 10% look-through rule does not apply to § 3(c)(7) funds. However, if the secondary fund invests a large portion of its assets in a single § 3(c)(7) fund, it may be deemed to have been "formed" for the purpose of investing in the underlying fund. In such a case, owners of the secondary fund will be deemed owners of the underlying fund, which will be required to register if any one of them is not a "qualified purchaser."[275] The SEC staff

[270] 15 U.S.C. 80a-3(a)(1).
[271] See Levin, supra note 19, ¶ 1008.
[272] 15 U.S.C. 80a-3(c)(1).
[273] 15 U.S.C. 80a-3(c)(7)(A). A "qualified purchaser" is a natural person or company that owns not less than $5,000,000 in investments, or an entity that owns less than $25,000,000 in investments. 15 U.S.C. 80a-2(51)(A).
[274] 15 U.S.C. 80a-3(c)(1)(A).
[275] 15 U.S.C. § 80a-48(a). See Levin, supra note 19, ¶ 1008.

has indicated that an investment of 40% of fund assets in a "lower" fund will trigger look through.[276] Obviously, insofar as these "look-through" rules (and the need to avoid them) require individualized scrutiny of each secondary resale of LP interests, the liquidity of the market in "secondaries" will be made less efficient.

c. Publicly Traded "Private" Equity Vehicles

Publicly traded private equity vehicles represent a paradigm shift, both in terms of the liquidity that they offer and the rules and regulations by which they are governed. Acquisition exits and secondary buyouts allow venture capitalists and private equity funds to exit discrete portfolio company investments. Secondaries enable limited partners to do the same with respect to discrete investments in venture capital and private equity funds. In contrast, publicly traded private equity vehicles provide a private equity fund with immediate access to an "evergreen" supply of capital, and public investors with the permanent possibility of exit into a liquid secondary market. While such vehicles have long existed, private equity funds in Europe and the U.S. recently have developed new models, which they have used to raise unprecedented sums. These hybrid vehicles, particularly those launched in the U.S., pose a challenge to the traditional distinction between the public and private equity markets.

i. Business Development Companies

In 1980, Congress amended the 1940 Act to establish an alternative regulatory schema for BDCs, closed-end investment companies formed for the purpose of investing in and providing managerial advice to small, private companies and distressed firms.[277] Thus, a closed-end investment company with more than seventy percent of its portfolio invested in eligible

[276] American Bar Ass'n Section of Business Law, SEC No-Action Letter, 1999 WL 235450 (Apr. 22, 1999). See, Gerald T. Lins et al., HEDGE FUNDS AND OTHER PRIVATE FUNDS: REG. AND COMP. § 10:3
[277] 15 U.S.C. § 80a-6(f). See, generally, Reginald L. Thomas & Paul F. Roye, *Regulation of Business Development Companies under the Investment Company Act*, 55 S.CAL.L.REV. 895, 912-929 (1982).

securities (or cash) and the ability to provide managerial assistance may elect to be treated as a BDC, rather than as an "investment company" subject to the full weight of the 1940 Act.[278] The exemption permits a venture capital or private equity fund organized as a BDC to engage in financing activities forbidden to mutual funds and other "investment companies" while nevertheless offering securities to public investors.[279] Subchapter M of the Internal Revenue Code provides that a BDC meeting certain requirements may elect to be treated as a partnership for federal income tax purposes, like a traditional venture capital or private equity fund.[280]

As noted supra in III.c.i., a number of large private equity funds recently have launched BDCs. Access to the liquidity of public equity markets is the principal reason that venture capital and private equity funds elect registration and regulation as BDCs rather than seeking complete exemption from the requirements of the 1940 Act. Unlike exempt funds, BDCs have immediate access to a permanent pool of contributed capital and may operate for an indefinite life. Furthermore, they may issue any type of security, including stock options to employees and secondary equity offerings to the public.[281] To qualify for BDC status, a fund first must register a class of its securities under Section 12 of the 1934 Act.[282] It must also have a board of directors comprised of a majority of non-"interested persons."[283] After registration, a BDC may offer its securities to the public, subject to the requirements of the 1933 Act, discussed infra at

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[278] 15 U.S.C. §§ 80a-2(48) & 80a-55(a).

[279] See 15 U.S.C. §§ 80a-61through 80a-63. A related exemption enables most general partners of BDCs to avoid registering as "investment advisers" pursuant to the Investment Advisers Act of 1940. The Act exempts investment advisors with fewer than fifteen clients from registration, and provides that no shareholder, partner, or beneficial owner of a BDC shall be deemed a client of an investment advisor unless she is a client of such investment advisor in another capacity. Thus, the number of BDC shareholders will not influence whether its investment advisers will be required to register. 15 U.S.C. § 80b-3(b)(3).

[280] 26 U.S.C.A. §§ 851-855.

[281] 15 U.S.C. 80a-61.

[282] 15 U.S.C. 80a-54(a).

[283] 15 U.S.C. 80a-56(a).

IV.c.iii.[284] A publicly traded BDC is subject to the annual reporting requirements of Section 64 of the 1940 Act and the periodic reporting requirements of Section 13 of the 1934 Act.[285]

A closed-end investment company must meet certain asset allocation requirements in order to qualify as a BDC. A BDC must invest more than seventy percent of the value of its assets in the securities of "eligible portfolio companies," distressed companies, and cash or cash equivalents.[286] An "eligible portfolio company" is a domestic operating company that meets the SEC's criteria for small businesses, is controlled by the BDC, or does not have any class of securities listed on a national securities exchange.[287] A BDC will be an "accredited investor" for the purposes of Regulation D, facilitating private placements of portfolio company securities.[288]

A BDC may elect to be treated as a regulated investment company ("RIC") under Subchapter M of the Internal Revenue Code, allowing it to avoid paying entity-level federal income tax on income distributed to its shareholders.[289] Most do. A BDC electing RIC status must distribute at least 90% of its taxable income to its shareholders each year.[290] Like the 1940 Act, the tax code imposes asset allocation restrictions upon a closed-end investment company electing special treatment. However, the disparate requirements of the tax and securities law are, to some degree, at cross-purposes. Whereas the 1940 Act restrictions direct BDCs to allocate the bulk of their assets in venture capital and private equity investments, Subchapter M requires that RICs be diversified: no more than twenty-five percent of a RIC's assets may be invested in the

[284] Some special rules apply to public offerings of securities in business development companies. See 17 C.F.R. §§ 230.480-489. Moreover, the liberalized communication and free writing prospectus rules established by Securities Offering Reform of 2005 are not available to BDCs. 17 C.F.R. § 230.164(f).
[285] 15 U.S.C. 80a-64 & 78m.
[286] 15 U.S.C. 80a-55(a).
[287] 15 U.S.C. 80a-2(46) & 17 C.F.R. §270.2a-46. Follow-on investments in a company that is no longer an "eligible portfolio company" will be counted towards the seventy percent requirement. 17 C.F.R. §270.55a-1.
[288] 17 C.F.R. § 230.501(a)(2).
[289] 26 U.S.C.A. § 11(c)(3).
[290] 26 U.S.C.A. § 852(a).

securities of any one issuer, or any two or more issuers that are controlled by the RIC and engaged in similar or related trades or businesses.[291]

The securities and tax rules and regulations governing BDCs allow venture capital and private equity firms to access the public equity markets without giving up many of the advantages of the limited partnership form. However their asset allocation requirements, along with the dividend requirements of Subchapter M, have limited the usefulness of the BDC form. The fact that the shares of publicly-traded BDCs often trade at less than net asset value, as noted supra in III.c.i, raises risk that unhappy retail investors and their attorneys will pursue the civil remedies available to them under the 1933 and 1934 Acts. Recently, private equity firms with broad "brand" recognition have created alternative vehicles with which to access the liquidity of the public capital markets.

ii. Initial Public Offerings in Europe

In Spring 2006, both KKR and Apollo launched publicly traded private equity vehicles, KPE and AAA, on Euronext Amsterdam N.V. Both offerings involved a public offering of common units and a Rule 144A private placement of restricted depository units ("RDUs") to QIBs in the United States. Each vehicle is a closed-end investment fund structured as a limited partnership organized under the laws of Guernsey, and makes its investments through a separate Guernsey limited partnership of which it is the sole LP. Public investors in these vehicles are in the position of LPs in a private equity fund dedicated mainly to investing in the associated "family" of funds. KKR and Apollo principals manage the subsidiary investment partnerships, and returns to investors are net of fees and carried interest. Thus, these publicly traded private equity vehicles are akin to BDCs without the asset allocation, disclosure, or dividend requirements imposed by U.S. securities and tax law.

[291] 26 U.S.C.A. § 851(b)(3)(B).

In order to undertake an IPO on Euronext Amsterdam, the prospective issuer must file an application for approval of its prospectus with the Netherlands Authority for the Financial Markets (*Autoriteit Financiële Markten*, "AFM").[292] The new prospectus requirements of the Financial Supervision Act (*de Wet op het financieel toezicht*, which entered into force on January 1, 2007 (after these IPOs), are those of the European Commission Prospectus Regulation.[293] In order to make a public offering, a closed-end investment company must disclose information about its corporate structure, capital structure, historical financial information, risk factors, etc.[294] After going public, the company must comply with European financial reporting rules, including the biannual reporting requirements of the Transparency Directive of 2004 and the continuous material disclosure obligation imposed by the Market Abuse Directive of 2003.[295] However, as noted supra in III.c.ii, KPE's 2006 Annual Report provides investors with little information about the performance of its underlying investments. KPE informs investors merely of the cost and fair value of its investments in KKR private equity funds, large portfolio companies, and opportunistic investments. The fair value of its private equity investments is estimated by KPE principals based on EBITDA, discounted cash flow, or liquidation analysis; the method used to value particular investments is not disclosed.[296] Of course, there is no requirement that managers certify KPE's financial statements or that an outside auditor verifies its internal controls.

By publicly offering securities only to non-U.S. investors on Euronext Amsterdam, these publicly traded private equity vehicles escape the registration and reporting requirements of the

[292] Unofficial draft translation of Financial Supervision Act (Sept. 28, 2006), § 5:19, available at http://www. minfin.nl/en/subjects,financial-markets/Financial-Supervision.html.
[293] Id. at § 5:13. The Prospectus Directive (2003/71/EC) of November 4, 2003, is accompanied by the detailed requirements of the Commission Regulation (2004/809).
[294] Commission Regulation (2004/809), Art. 3-6, Art. 18.
[295] 2004/109/EC & 2003/6/EC.
[296] KKR Private Equity Investors, L.P., 2006 ANNUAL FINANCIAL REPORT (March 27, 2007) F-23–F-27 & F-30.

1933, 1934, and 1940 Acts; however, they nevertheless are able to access the U.S. capital markets through private placements under Rule 144A. Euronext Amsterdam, as successor in interest to the Amsterdam Stock Exchange, is a "Designated Offshore Securities Market" under Rule 902(b) of Regulation S.[297] Thus, because sales of their common units occur "outside the United States," these securities are exempt from U.S. regulation.[298] In order to ensure compliance with Regulation S, both KPE and AAA imposed ownership and transfer restrictions upon their common units.[299] The RDUs issued to U.S. investors also are subject to ownership and transfer restrictions designed to maintain their exemptions from registration under the 1940 Act.[300] Private placement of the RDUs with U.S. investors subjects KPE and AAA to civil liability under Section 10(b) and Rule 10b-5 of the 1934 Act; however, there are no public unitholders on behalf of whom to bring a class action.[301]

Though Dutch law treats the managing partners of these publicly traded vehicles as "Collective Investment Schemes" subject to certain disclosure requirements, the partnership law of Guernsey governs the relationship of investors to the vehicles and the managing private equity firm.[302] The Guernsey limited partnership form is familiar: a closed-end vehicle that offers limited partners limited liability and freedom from entity-level taxation, and is directed by general partners who receive management fees and a carried interest in the fund's returns. Guernsey imposes no further disclosure or audit requirements upon partnerships organized under

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[297] 17 C.F.R. § 230.902(b). Euronext Amsterdam N.V., SEC No-Action Letter, 2006 WL 1071567 (April 7, 2006). See, generally, Scott, supra note 264, Ch. 2.F.
[298] 17 C.F.R. § 230.903.
[299] KKR Private Equity Investors, L.P., Preliminary Offering Memorandum (April 18, 2006) 151; AP Alternative Assets, Prospectus (July 31, 2006) 160-162.
[300] KKR Private Equity Investors, L.P., Preliminary Offering Memorandum, 165-172; AP Alternative Assets, Prospectus, 160-162.
[301] 15 U.S.C.A. § 78j(b); and, 17 C.F.R. § 240.10b-5.
[302] James Anderson & Adrian Deitz, *Seeking a Wider Public*, INT'L.FIN.L.REV. (Sept. 2006) 44-45.

its laws;[303] however, both KPE and AAA have covenanted to make annual and quarterly disclosures to investors pursuant to U.S. GAAP. Furthermore, according to the terms of the agreements creating these webs, investors in the publicly traded vehicle waive any fiduciary duties owed to them by members of the private equity firm general partnership.[304] Guernsey courts will afford considerable deference to the terms of such agreements, affording "higher" private equity entities and principals within these "families" insulation from derivative lawsuits.

A U.S.-based venture capital or private equity firm realizes several advantages by choosing to launch a publicly traded, Guernsey registered vehicle on Euronext Amsterdam. First, the issuer may bring its offering to market more quickly than in the United States, while retaining both its home language and its home currency. The AFM is required to notify an applicant for an IPO of its decision within a maximum of twenty working days.[305] Both KPE and AAA issued prospectus in English, and their common units trade in Dollars on the exchange. Second, publicly traded private equity vehicles listing on Euronext avoid the asset allocation restrictions imposed upon BDCs by the 1940 Act as well as the dividend requirements of the Internal Revenue Code. For example, in January 2007, KPE purchased $700 million in publicly traded senior convertible bonds issued by Sun Corporation, assets that would count against the seventy percent private "basket" required of a BDC.[306] Third, while the vehicle is subject to substantially equivalent ongoing disclosure requirements, neither its periodic filings nor its corporate governance need comply with the 1934 Act or SOX. Finally, while any offering to public investors will be subject to litigation risk, the expected value of such risk is considerably smaller in Amsterdam than New York. For example, an inaccurate prospectus summary will

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[303] Ben Morgan, *Guernsey*, THELAWYER.COM (Nov. 7, 2005), available at http://www.thelawyer.com/cgi-bin/item.cgi?id=117415&d=122& h=24&f=46
[304] See, e.g., KKR Private Equity Investors, L.P., PRELIMINARY OFFERING MEMORANDUM, 20 & 51-53.
[305] Unofficial draft translation of Financial Supervision Act (Sept. 28, 2006), § 5:9a.
[306] Emily Thornton, *Private Equity Goes Public*, BUSINESSWEEK (March 19, 2007) 76.

give rise to liability only if it is misleading when read together with the other parts of the prospectus.[307] And, of course, the Netherlands does not have a class action device for fraud arising after the offering.

iii. Initial Public Offerings in the United States

In February 2007, FIG, a U.S.-based hedge fund and private equity manager, sold a ten percent stake in its asset management business to the public in an IPO on the New York Stock Exchange. In March, BX, a successful manager of large private equity and real estate investments, filed a prospectus for a similar, albeit larger, U.S. IPO.[308] In contrast to KPE and AAA, public investors in FIG and BX are in the position of "passive" members of the managers' general partnership, sharing in the fees and carried interest earned by the management of the principals' "family" of funds.[309] While neither vehicle will register as an "investment company" or BDC under the 1940 Act, both will be subject to the full scope of U.S. securities regulation.

The FIG and BX IPOs will be regulated under the 1933 Act. Before making an IPO of securities in the U.S., an issuer must file a registration statement with the SEC.[310] During the "waiting period" between the time the registration statement is filed and its approval by the SEC, the issuer may make oral, but not written, offers of securities to investors, but neither may sell nor deliver the securities.[311] Furthermore, any communication must comply with the prospectus requirements of Section 10, and the detailed provisions of Regulation S-K.[312] The approval process is slow. While Section 8(a) provides that the SEC must notify an applicant for an IPO of its decision within a maximum of twenty days, in practice the process may take four to six

[307] Id. at § 5:14.
[308] Dennis K. Berman & Henny Sender, *Big Buyout Firm Prepares to Sell Stake to Public*, WALL.ST.J. (March 19, 2007) A1.
[309] Fortress Investment Group LLC, FORM S-1 (Nov. 8, 2006) 1; Ben Maiden, *First Hedge Fund IPO Reveals Industry's Future*, INT'L.FIN.L.REV. (Nov. 15, 2006).
[310] 15 U.S.C. § 77e.
[311] Id.
[312] 15 U.S.C. §§ 77e(b)(1) & 77j; 17 C.F.R. §§ 229.501-512.

weeks.[313] After the SEC deems the issuer's registration statement "effective," sale and delivery may proceed, accompanied by a statutory prospectus (or access thereto).[314] Issuers have an ongoing obligation to amend or supplement the prospectus to reflect material developments after the effective date;[315] a post-effective amendment will not be effective without SEC approval.[316]

After its IPO, an issuer will be subject to the periodic disclosure requirements of the 1934 Act, as modified by SOX. The issuer must furnish annual and quarterly reports containing extensive information about its financial performance, along with special reports upon the occurrence of material events, such as a change in management or control.[317] The financial statements in the issuer's annual report must be approved by an outside auditor.[318] SOX requires senior management to report on "the effectiveness of the internal control structure and procedures of the issuer for financial reporting," and the outside auditor to "attest to, and report on, the assessment made by the management of the issuer" in the annual report.[319] The CEO and CFO must certify the veracity of the annual report, including their assessment of the firm's internal controls,[320] and are subject to criminal sanctions for knowing material misrepresentations of financial information.[321] SOX also requires firms to have completely audit committees.[322] NYSE governance rules impose further requirements upon listed companies: a majority of the board, and the entire compensation and nominating/corporate governance

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[313] 25 U.S.C. § 77h(a) requires a decision within twenty days. In practice, the prospective issuer will file delaying amendments pursuant to Rule 473 until the SEC approves its registration statement. 17 C.F.R. §230.473.
[314] 15 U.S.C. §§ 77e(b)(2). Under Rule 172, prospectus access equals delivery. 17 C.F.R. § 230.172.
[315] 17 C.F.R. § 230.424(b). See, SEC v. Manor Nursing Centers Inc., 458 F.2d 1082, 1098 (2d Cir. 1972) (failure to amend or supplement prospectus to reflect post-effective date developments strips it of compliance with Section 10, violating Section 5(b)(2)).
[316] James D. Cox et al., SECURITIES REGULATION: CASES AND MATERIALS (4th ed. 2004) 209.
[317] 15 U.S.C. § 78m.
[318] 15 U.S.C. § 78m(a).
[319] 15 U.S.C. § 7262; 17 C.F.R. § 240.13a-15.
[320] 15 U.S.C. § 7241.
[321] 18 U.S.C. § 1350; 17 C.F.R. § 240.13a-14.
[322] 15 U.S.C. § 78j-1(m)(3).

committees, must be composed of independent directors.[323] FIG, a limited liability company, complies with both SOX and NYSE requirements.[324] BX, a limited partnership managed by a GP, complies with SOX but relies upon an exemption to the NYSE rules, discussed supra at III.c.iii.[325] The costs of SOX compliance, and the risks of noncompliance, are high for U.S. issuers.[326] Indeed, both compliance and noncompliance feature prominently as risk factors in both FIG and BX prospectuses.[327]

The 1933 and 1934 Acts impose liability for false and misleading information upon the issuer and related parties. Section 11(a) of the 1933 Act provides a rescissionary remedy to purchasers of securities in an initial public offering who allege that the issuer's registration statement contained an untrue statement or misleading omission of material fact.[328] The issuer is subject to strict liability; however, underwriters, accountants, and other experts who certified the registration statement may avail themselves of a due diligence defense.[329] Section 12(a)(2) provides purchasers with grounds for recovery on the basis of false or misleading statements other than those in the registration statement.[330] Section 18(a) of the 1934 Act allows holders of the issuer's securities to recover for losses caused material misrepresentations or omissions made after the IPO is over.[331] However, it is Section 10(b) and Rule 10b-5 of the 1934 Act that provide the most common grounds for civil liability.[332] Unlike Section 18(a), the plaintiff need

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[323] NYSE LISTED COMPANY MANUAL § 303A.01, 303A.04, & 303A.05.
[324] FIG's audit, nominating, and compensation committee charters are available at http://phx.corporate-ir.net/phoenix.zhtml?c=205346&p=irol-govhighlights.
[325] NYSE LISTED COMPANY MANUAL § 303A.00 provides that "[d]ue to their unique attributes, limited partnerships […] need not comply with the requirements of Sections 303A.01, 303A.04 or 303A.05."
[326] INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION, supra note 3, 124-127.
[327] Fortress Investment Group LLC, FORM S-1 (Nov. 8, 2006), 27; The Blackstone Group, L.P., FORM S-1 (March 22, 2007) 28.
[328] 15 U.S.C. §77k(a).
[329] 15 U.S.C. §77k(b) & (c).
[330] 15 U.S.C. §77*l*(a)(2).
[331] 15 U.S.C. §78r(a).
[332] 15 U.S.C. §78j(b); 17 C.F.R. § 240.10b-5.

not prove reliance upon false statements by the issuer to recover.[333] Shareholder class actions brought under Rule 10b-5 impose substantial costs upon publicly traded companies in the U.S.[334] And, of course, issuers, directors, and officers are subject to criminal liability for fraud.[335]

However, because FIG and BX are structured as a holding company and holding partnership, respectively, the information subject to liability for misrepresentation or omission is limited to the financial statements of the publicly traded entities. The FIG and BX financial statements will not report the financial and operating performance of the private equity and hedge funds in which FIG and BX invest, or the portfolio companies and other opportunities in which these funds, in turn, invest. Nor will FIG and BX disclose proprietary information regarding the management, prospects, and performance of their operating entities. As noted supra at III.c.iii, the deconsolidation undertaken by BX allows it to account for its investments in Blackstone Group's operating entities using the equity method, as modified by the fair value option provided by SFAS 159.[336] Using this method, BX records its initial investments in Blackstone's operating entities at cost; each year, it will write up (down) their value and record the change as income (loss) from investing. In addition to the consequences for financial reporting discussed supra, the equity method allows BX to record the unrealized appreciation of Blackstone funds' investments as its own income, regardless of dividends received.

FIG and BX also are subject to certain securities and tax law risks based upon their untested organizational structures. Both entities invest primarily in the restricted securities of their operating entities, limited partnerships that manage their underlying investment businesses.

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[333] Basic, Inc. v. Levinson, 485 U.S. 224, 243-44 (1988); but see, In re PolyMedica Corp. Sec. Litig., 432 F.3d 1, 26 (1st Cir. 2005).
[334] INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION, supra note 3, 71-80.
[335] Id. at 84-91.
[336] APB 18 (1971) governs the use of the equity method under U.S. GAAP; see also, SFAS 159: *The Fair Value Option for Financial Assets and Financial Liabilities* (2007).

However, both also claim that they are not "investment companies" as defined by the 1940 Act because, as BX argues, they are "engaged primarily in the business of providing asset management and financial advisory services and not in the business of investing, reinvesting or trading in securities."[337] That is, BX claims, although its "operating entities" are GPs of private equity funds that would be regulated as "investment companies" absent an exemption, it is not itself an "investment company" but a service provider. Adverse consequences would follow if either entity were recharacterized as an "investment company" subject to the 1940 Act. As FIG notes, regulation as an investment company "could make it impractical for us to continue our business as contemplated."[338]

The SEC's approval of FIG's registration statement seems to indicate its acceptance of the proposition that FIG and BX earn the bulk of their income from the provision of financial services; however, these grounds for their exemption from "investment company" regulation may cause the IRS to challenge their claimed exemptions from entity-level taxation.[339] Both FIG and BX are entities that normally would be classified as "publicly traded partnerships" and subject to U.S. federal income taxation as corporations.[340] Both entities rely on the "qualifying income" exemption from this tax treatment. The "qualifying income" exception is available to an entity that otherwise would be a "publicly traded partnership" when at least 90% of its income consists of "qualifying income": interest income, dividends, real property rents, and capital gains.[341] In essence, FIG and BX have told the SEC that their income does not derive from investments, and the IRS that, in fact, it does. There is a real risk of challenge by the IRS.[342] As

[337] The Blackstone Group, L.P., FORM S-1 (March 22, 2007) 49.
[338] Fortress Investment Group LLC, FORM S-1 (Nov. 8, 2006) 50.
[339] Id. at 152-153; The Blackstone Group, L.P., FORM S-1 (March 22, 2007) 201-202.
[340] 26 U.S.C. § 7704.
[341] 26 U.S.C. § 7704(c)(3).
[342] Emily Chasan, *Unusual IPO Tax Structure May Plague Blackstone*, REUTERS (March 30, 2007).

BX notes, the structure of these entities "involves complex provisions of U.S. federal income tax law for which no clear precedent or authority may be available."[343]

The stringent requirements and areas of uncertainty that characterize current U.S. rules and regulations do not seem to have deterred private equity funds from launching IPOs in 2007; however, they have shaped the form of the publicly traded private equity vehicles that have been launched, and may constrain further developments in this area. If KPE or AAA had undertaken its initial public offering in the U.S., it would have been subject to registration and regulation as an "investment company" or BDC. As noted supra in III.c.i, very few private equity funds have chosen to register as BDCs, due to the restrictions that thereby would be placed on their investments. Thus, the holding company/holding partnership structure utilized by FIG and BX is the only viable U.S. alternative to KPE and AAA. As we have seen, these structures are subject to considerable regulatory uncertainty. Moreover, they are not strictly analogous to the European entities. When it comes to publicly traded private equity vehicles, European public investors and U.S. institutional investors may be in the position of LPs in a venture capital or private equity fund; however, U.S. public investors must take a passive stake in the GPs' management business. It remains to be seen whether one position is superior from the point of view of public investors. However, without a compelling rationale, the present segregation of forms unnecessarily distorts the public market in private equity, reduces the options available to public investors, and hampers the competitiveness of U.S. private and public equity markets.

V. CONCLUSION: THE FUTURE OF PUBLIC CAPITAL MARKETS

This paper has described the recent emergence of three vibrant secondary markets in private equity: secondary buyouts, secondaries, and publicly traded private equity vehicles. Each of these liquidity technologies provides an alternative to the public equity market for investors in

[343] The Blackstone Group, L.P., FORM S-1 (March 22, 2007) 53.

private equity. Like acquisition exits, secondary buyouts allow venture capitalists and private equity funds to exit individual portfolio company investments without an IPO. Secondaries enable LPs to exit their private equity investments before their wind-up and termination of their funds. Publicly traded private equity vehicles transform the basic relationship between private equity and public equity markets, providing funds with access to a permanent pool of capital and public investors with the liquidity of traditional secondary trading. In order to decide whether these developments are to be encouraged and how they are to be regulated, we must evaluate them in terms of the basic principles of U.S. securities regulation: investor protection, the maintenance of fair, orderly, and efficient markets, and the facilitation of capital formation.

a. Secondary Buyouts

The further development of markets in secondary buyouts and secondaries should be encouraged, and the future shape of these markets left to the marketplace. Neither secondary buyouts nor the market in secondaries implicates the investor protective rationale for securities regulation. For practical purposes, federal securities laws and regulations limit primary private equity investment to "accredited investors," and permit the resale and purchase of those investments by such "accredited investors."[344] Investors able to "fend for themselves"[345] should have no need for regulation to protect them in private secondary markets. Of course, behavioral economics suggests that putatively "sophisticated investors" may be susceptible to the same irrationalities as the average public investor.[346] However, there is no evidence that either the market in secondary buyouts or the market in secondaries has been bereft of adequate disclosure

[344] 17 C.F.R. § 230.501(a) (1989).
[345] 346 U.S. 119, 125.
[346] Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics about Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 631 (May 1996).

or plagued by fraud. Indeed, reputational concerns play an important role in constraining fraud, particularly in the market for secondary buyouts.

There is no principled reason why secondary buyouts involving the sale of stock should give rise to a federal cause of action arising under Section 10(b) and Rule 10b-5,[347] when the same transaction structured as a sale of assets would not. A secondary buyout generally involves the sale of an entire operating company; even if it is structured as a sale of stock, a secondary buyout has none of the features of an "investment contract" under the test articulated by the Supreme Court in SEC v. W.J. Howey Co.[348] Of course, the express inclusion of "stock" in the statutory definition of a "security"[349] would seem to preclude a return to the "sale of business" doctrine, particularly after its rejection by the Court in Landreth Timber Co. v. Landreth[350] and Gould v. Ruefenacht.[351] Furthermore, as the Court recognized in Landreth Timber, judicial determination of whether the sale of stock in a controlled company is a "sale of business" would give rise to transactional uncertainty and administrative difficulty.[352]

In order to facilitate secondary buyouts without reviving the "sale of business" doctrine, the SEC should allow parties to a secondary buyout to agree to submit claims arising under the Section 10(b) and Rule 10b-5 to mandatory arbitration. The Committee on Capital Markets Regulation has suggested that the SEC permit public companies to contract with their investors to provide for alternative resolution of public securities litigation, including mandatory arbitration.[353] The case for allowing sophisticated parties to a secondary buyout to do so is even

[347] 15 U.S.C.A. § 78j(b); and, 17 C.F.R. § 240.10b-5.
[348] 328 U.S. 293, 299 (1946). An "investment contract" is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party." A secondary buyout is a singular enterprise in which an investor will profit from its own efforts.
[349] See 15 U.S.C. §§ 77(b)(1) & 78(c)(a)(10).
[350] 471 U.S. 681, 697 (1985).
[351] 471 U.S. 701, 705 (1985).
[352] 471 U.S. 681, 696-697.
[353] INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION, supra note 3, 109-112.

more compelling. Enabling parties to precisely allocate the risks of their transaction would reduce the overall expected costs of the deal, which in turn would facilitate more deals. Because the parties would continue to have the rescissionary "escape hatch" provided by ABRY Partners for cases of intentional fraud, they would have no additional incentive to lie. Mandatory arbitration for securities fraud claims arising from secondary buyouts merely would extend Vice Chancellor Strine's transactional "blueprint," and eliminate a duplicative federal cause of action. The discipline of the market for LPs' capital and the importance of reputation should continue to constrain both incautious buyers and unscrupulous sellers in this secondary market

b. Secondaries

Unlike the market in secondary buyouts, which remains a small subset of the mergers and acquisitions market, the development of electronic markets in secondaries raises important questions relating to the maintenance of fair, orderly, and efficient equity markets. First, is the continued exclusion of "accredited investors" from the Rule 144A market fair, particularly in light of Nasdaq's plan to expand and enhance the Rule 144A market in private equity securities through its Portal Trading System? Second, is the expansion of parallel private markets in equity securities unfair to public investors, or inefficient from the perspective of the public equity market? As discussed supra at IV.b.ii, Rule 144A establishes a private market for the placement and trading of unregistered securities; however, only QIBs, institutions with at least $100 million invested in securities and an audited net worth of more than $25 million, may participate in this market.[354] Though the Rule 144A market has been dominated by private placements rather than secondary trading, the SEC always has viewed it as "the first step toward achieving a more liquid and efficient institutional resale market for unregistered securities."[355] The development

[354] 17 C.F.R. § 230.144A.
[355] Securities Act Release No. 33-6862, supra note 265, at 80,649.

of the Portal Trading System, which will provide quotes for unregistered securities, is likely to enhance secondary trading on the Rule 144A market.

While "accredited investors" may make primary investments in restricted securities and engage in secondary resales independently or via electronic systems like NYPPE, Portal (and other, private Rule 144A placement and trading systems) are "sealed" off from them.[356] The SEC's avowed purpose in restricting the Rule 144A market to QIBs is to "establish a level at which it can be confident that participating investors have extensive experience in the private resale market for restricted securities."[357] Of course, a particular level of investment holdings or net worth is an imprecise proxy for sophistication.[358] Putting this general objection aside, however, it is unclear why both "accredited investors" and QIBs are deemed presumptively able to make primary investments in restricted securities, but only the latter are permitted to engage in free secondary resales of the same securities in the Rule 144A market. Perversely, the apparently less sophisticated (and certainly less wealthy) "accredited investors" are required to use a less liquid, less transparent secondary market than their apparently more sophisticated brethren. This segregation no doubt contributes to the persistent inefficiency of the "retail" market in secondaries. Ending it would be unlikely to undermine investor protection, insofar as most QIB participants in the Rule 144A market (who act as underwriters as well as traders) are constrained by reputational considerations.[359] Opening the Rule 144A market to "accredited investors" would allow these investors, who generally are sellers rather than buyers of

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[356] Denis T. Rice & Charles P. Ortmeyer, SECURITIES REGULATION FORMS (ed. Feb. 2007) § 11:14.
[357] Securities Act Release No. 33-6806, 1998 WL 241209 (Oct. 25, 1988), Fed. Sec. L. Rep. (CCH) ¶ 84,335, at *17; quoted in Lawrence R. Seidman, *SEC Rule 144A: The Rule Heard Round the Globe—Or the Sounds of Silence?* 47 BUS. LAW. 333, 341 (Nov. 1991).
[358] Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291, 293 (Summer 1994).
[359] On the importance of underwriter reputation in debt issues, see Lily Fang, *Investment Bank Reputation and the Price and Quality of Underwriting Services*, 60 J. OF FIN. 2729 (2005).

secondaries, greater access to institutional buyers, enhancing both the fairness and efficiency of this secondary market.

Whether “accredited investors” are allowed access to the Rule 144A market or not, the development of this market poses a further question pertaining to the fairness and efficiency of a parallel, private secondary market in equity securities. Legislative concerns regarding the possible development of parallel securities markets were raised at the passage of Rule 144A, and resulted in the creation of its non-fungibility requirement. In a letter to SEC Chairman Richard C. Breeden, Representatives John D. Dingell and Edward J. Markey signaled their concern about “the possible development of a two-tiered securities market for U.S. investors, one public and one private, and the serious negative implications of such a development,” including the diminished availability of quality investments to small investors and the greater likelihood that poor investments would be passed on to unwitting investors through mutual and pension funds.[360] An enhanced Rule 144A market in private equity securities also raises a standard efficiency consideration: at a certain point, the transaction costs arising from multiple investors seeking private information about a single security will be greater than those associated with public registration of that security, making a mandatory disclosure rule the efficient choice.[361]

In my view, these fairness concerns are misplaced. In order to protect public investors, U.S. regulators have enacted rules and regulations based on a disclosure philosophy as applied to securities that will be offered to the public, not a distributional philosophy that determines which securities must be offered to the public. This philosophy was distilled to its essence in a 1923 article authored by Huston Thompson, chairman of the Federal Trade Commission under

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[360] *Rule 144A—Congressional Letter*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) 84,600, at 80,695, quoted in Hicks, Resales supra note XX, §10A:1 n. 10.

[361] See Steven C. Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 EMORY L. J. 591, 641 (Spring 1996).

President Woodrow Wilson. "[T]he solution" to the problem of securities fraud "must be effected through a system of publicity which shall protect the public by informing the investors as to the securities to be sold by giving the prospective purchaser a full opportunity to be enlightened and then leaving to him the responsibility of purchase."[362] As is well known, this solution was adopted by Congress in the 1933 and 1934 Acts.[363] The concerns raised by Representatives Dingell and Markey regarding the development of a "two-tiered securities market" has less to do investor protection than with the allocation of investment opportunities among different kinds investor. In effect, the legislators suggest in their letter, the development of private markets must be constrained, lest "quality investments" be taken away from public investors. By this logic, all private markets are suspect, unless composed entirely of poor investments. In addition to being unprincipled, restrictions based on such fairness concerns undoubtedly will be undermined by the continued expansion of private equity.

Fears about the relative inefficiency of an expanded market in secondaries also miss the mark. First, rational investors should factor the cost of diligence into the price that they are willing to pay for private equity. Thus, the aggregate cost of all private investors' information production ultimately should be borne by the issuer.[364] When the "tipping point" is reached—when the transaction costs arising from multiple investors seeking private information about a single security are greater than those associated with public registration—a rational issuer will enter the public equity market. Of course, neither markets' pricing nor issuers' foresight are perfect, and there are positive externalities to mandatory disclosure. Nevertheless, improving the liquidity of the market in secondaries should not result in an inefficient shift of issuer preferences

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[362] Huston Thompson, *Regulation and Sale of Securities in Interstate Commerce*, 9 AMERICAN BAR ASS'N J. (1923) 157, quoted in Joel Seligman, THE TRANSFORMATION OF WALL STREET (3d ed. 2003) 50.
[363] Seligman, supra note 362, 39-40.
[364] Draho, supra note 48, 42.

from public to private equity. Estimates of the current cost of illiquidity in the private equity market range from 7 to 14 percent of firm value; this factor alone makes the cost of private equity 7.5 to 15% higher than that of public equity.[365] Any improvement in the liquidity of secondary markets in private equity is unlikely to eliminate this difference entirely. Moreover, even a dramatic improvement in private market liquidity would have no effect on the other benefits to issuers of going public, either in terms of the direct cost of capital or in terms of indirect benefits like the availability of new financing options (e.g., convertible debt).[366]

If anything, the goal of fostering capital formation should lead regulators to encourage the development of the market in secondaries (as well as secondary buyouts), insofar as improved secondary market liquidity will lower the cost of capital to private equity firms and their portfolio companies. Politically, however, such regulatory change may be infeasible. Contemporary perceptions of the private equity industry bear more than a passing resemblance to SEC Chairman William O Douglas's 1937 characterization of NYSE as a "private club" with "elements of a casino."[367] If anything, greater regulatory scrutiny of private equity—and restriction of its resale—seems likely.[368]

c. Publicly Traded "Private" Equity Vehicles

The publicly traded private equity vehicles launched in Europe and the U.S. challenge the traditional separation between the private and public equity markets. Public investors are offered the opportunity to invest in private equity, without suffering any loss in secondary market liquidity; private equity firms amass a permanent source of capital, without being subjected to the governance or disclosure regimes applied to traditional public companies. These new

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[365] Id., 40
[366] Id., 60.
[367] Qutoed in Seligman, supra note 362, 73.
[368] See, e.g., Weinberg & Vardi, supra note 71; and, Kinsley, supra note 174.

vehicles are the market's current solution to the limits of both traditional private equity funds and BDCs. While they raise certain issues related to investor protection, the maintenance of fair, orderly, and efficient markets, and the facilitation of capital formation, their further development should be encouraged by U.S. regulators absent compelling evidence that they cause harm.

In order to protect public investors, it may be necessary to alter the current U.S. corporate governance and disclosure regime as it applies to publicly traded private equity vehicles . As discussed supra in III.c.iii. and IV.c.iii, the vehicles launched in the U.S. are structured to avoid certain NYSE governance rules and reduce the extent of their required disclosure. Most importantly, by deconsolidating these entities remove the financial and operating performance of fund-level entities—upon which the ultimate performance of the public vehicles is built—from the annual and quarterly disclosures required to be provided to their investors. Because public investors are not provided with material information about these operating entities, they will find it very difficult judge their performance, or to bring securities fraud claims. Entities like FIG and BX are quite close to being "black boxes" to their public investors.

Private equity investment always has required a certain degree of "privacy," and these publicly traded vehicles incorporate some of private equity's traditional mechanisms for ameliorating the agency costs that might otherwise arise from a situation in which owners have neither the information nor the voting power to discipline management. Both FIG and BX use equity incentives to align the incentives of management with those of public unitholders, and adopt regular dividend policies designed to reduce the free cash flow problem. And, of course, traditional public companies also may use the same accounting techniques to distort the underlying reality of their financial and operating performance. Nevertheless, regulators may consider whether more fulsome disclosure of the performance of operating entities should be required of publicly traded private equity vehicles. In particular, the amount and timing of cash flows between operating entities, active funds, and portfolio companies would provide public investors with data about the actual risk and return characteristics of their investments — information that is obscured by the equity method of accounting.[369] This information already is provided to private equity fund LPs.[370]

Publicly traded private equity vehicles also raise concerns related to the maintenance of fair, orderly, and efficient markets. First, the practical differences that arise in the application of current disclosure requirements to publicly traded private equity vehicles versus traditional public companies pose a problem of competitive equity. For example, the business segment disclosure of General Electric (GE), a successful conglomerate, gives public investors with detailed information about the company's operating entities, as well as management discussion and analysis of their performance and future prospects.[371] In contrast, the segment disclosure of BX will provide information about the performance of four broad divisions—corporate private equity, real estate, hedge funds, and financial advisory—but will not reach down much further. Of course, GE and BX are engaged in quite different lines of business; the disclosures made by Goldman Sachs Group, Inc., (GS) regarding its merchant banking commitments are not unlike those contemplated by BX.[372] Thus, the issue of competitive equity is a larger one regarding the differential treatment of operating versus financial conglomerates. Were GE to "deconsolidate" its underlying businesses and restructure itself as a holding partnership, its disclosure might come to resemble that of BX.

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[369] Ljungqvist & Richardson, supra note 31, 5.
[370] Id.
[371] General Electric Company, FORM 10-K (Feb. 27, 2007) 4-15.
[372] The Goldman Sachs Group, Inc., FORM 10-K (Feb. 6, 2007) 3-12.

A further concern related to the maintenance of fair, orderly, and efficient markets arises from uncertainties regarding the appropriate treatment of FIG and BX under the federal securities and tax law. As noted supra in IV.c.iii, recharacterization of either of these entities as an "investment company" for the purposes of the 1940 Act or a corporation for the purposes of the tax code would adversely affect their operations, and the value of their securities in the hands of public investors. The SEC and IRS should settle the treatment of publicly traded private equity vehicles in order to facilitate primary and secondary market liquidity for their securities.

Finally, the emergence of publicly traded private equity vehicles creates both opportunities and challenges for capital formation in the U.S. First, the fact that successful U.S.-based private equity firms chose to launch IPOs of BDC-like entities on Euronext Amsterdam should alert regulators to the failure of the BDC form as a publicly traded vehicle for private equity investing, and prompt their deregulation. In the words of an industry observer, "it is wrong to see the listed private equity sector manifesting only in an offshore pooled investment vehicle."[373] While FIG and BX now offer domestic vehicles for U.S. public investors to access the private equity sector, they do not provide a mechanism that puts the investor in the place of an LP to a private equity fund, as do KPE and AAA. Absent evidence that publicly traded private equity vehicles structured like KPE and AA cause harm, U.S. regulators should revise the 1940 Act to provide a more complete "menu" of private equity options to public investors.

Furthermore, the fact that public investors wish to invest in entities like FIG and BX should give rise to a reconsideration of certain aspects of U.S. regulation of public companies. Most obviously, the popularity of these entities evidences the desire of public investors to have access to the returns associated with pre-IPO and post-LBO venture capital and private equity investing. There is no question why this should be: between 1987 and 2006, annual returns to

[373] Anderson & Deitz, supra note 302, 44.

Blackstone Group were 30.8% (22.8% after fees), compared to 10.4% for the S&P 500 index. However, one must wonder why U.S. public companies cannot offer similar returns to their investors, and whether the current rules and regulations governing the securities market contribute to this problem. Perhaps a system that seeks to protect investors by regulating issuers, rather than by regulating investors directly, imposes burdens on public companies that rational investors (or their sophisticated intermediaries) gladly would trade for improved performance.[374] An vehicle like BX is a real-world test of this proposition: if an entity that does not comply with NYSE governance rules, discloses limited information to the market, and gives its unitholders few "shareholder rights" outperforms traditional public companies for a significant interval, the costs and benefits of the current regulatory regime should be reconsidered.

Ultimately, however, the success of publicly traded private equity vehicles—and, indeed, all private equity—depends upon vibrant a public equity market, and a vibrant IPO market in particular. The regulatory and liability costs imposed on public companies affect not only the public equity market, but the broader U.S. capital market, public and private. While secondary markets in private equity provide private equity investors with alternative paths to liquidity, they are no substitute for a vibrant and competitive public equity market.

[374] Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV 279, 282-285 (March 2000).