# A BLOW TO PUBLIC INVESTING: REFORMING THE SYSTEM OF PRIVATE EQUITY FUND DISCLOSURES

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*Private equity funds have managed for years to squeeze into a unique loophole in federal securities law. Because the funds generally solicit only a small number of wealthy, sophisticated investors, they are exempt from the disclosures normally mandated by federal securities laws. As a result, the funds have kept their investment information undisclosed, privately pursuing specialized investment strategies that yield high returns and allow investors to diversify outside the mainstream.*

*Due to recent lawsuits filed under state Freedom of Information Acts (FOIAs), many of the wealthiest investors in private equity funds, including public universities and state pension funds, must disclose information about their investments. Information about the funds in which they invest consequently is being cast into the public light for the first time. The reaction from the private equity community has been primarily negative, with some of the more prestigious funds going so far as to ban public institutional investors altogether.*

*This Comment explains how private equity firms are generally exempt from disclosing information about their investments under federal securities law. It then describes how state public disclosure laws intended to benefit the public may instead result in the exclusion of public institutions from the most lucrative private equity funds as the funds fight to keep their investment information and strategies private. Finally, the Comment considers statutory, regulatory, and political solutions to this problem, and it proposes a uniform state law that would balance the privacy of private equity firms with the public's desire to shed light on investment returns.*



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## INTRODUCTION

The private equity industry historically has been just that—private.[1] Yet following the stock market crash of 1929, Congress enacted legislation that aimed to protect investors, such as the Securities Act of 1933, the Securities Exchange Act of 1934, and several years later, the Investment Company Act of 1940 and the Investment Advisers Act of 1940. These acts protect investors from abuses in the investment community by mandating open disclosure for most securities and funds. Sunshine, it is said, is "the best of disinfectants."[2]

Congress, however, believed that some investors are too savvy to need the protection of mandated disclosure and thus enacted statutory provisions exempting certain firms, transactions, and securities from registration and public disclosure. Because private equity firms usually open their doors only to money from sophisticated institutional investors and high-net-worth individuals, they have managed for decades to avoid disclosure and keep information about the companies in which they invest—and the success or failure of particular investments—private.

Although state Freedom of Information Acts (FOIAs)[3] have been in place for decades, they only recently have begun to be used to compel the disclosure

1. Privacy in the private equity industry is informational. Historically, private equity has not been required to disclose any information about investors or investments. This Comment uses the terms "private equity" and "venture capital" interchangeably.

2. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY 92 (Frederick A. Stokes Co. 1932) (1914).

3. This Comment uses the term Freedom of Information Acts (FOIAs) to refer both to state FOIAs and to Public Records Acts (PRAs). Because the distinction between FOIAs and PRAs is simply titular, they collectively are referred to as FOIAs.

of private equity information. These statutes require disclosure of information by institutions supported by public money, such as government agencies, public universities, public pension funds, and most other state government entities. This creates a potential problem for the private equity industry, in which many of the largest and most frequent investors are public institutions. Faced with FOIA requests for information, public institutions have been forced to disclose information about their private equity investments in several high-profile cases and directives.[4] While the reaction in the venture capital industry has not been entirely uniform, many firms have expressed concern that such disclosures threaten the success of their future investments. While some states have exceptions protecting information considered "confidential," the availability of such provisions varies widely from state to state. To protect themselves from this perceived threat and to maintain their desired level of privacy, several funds have asked public institutions to exit the funds, or have chosen to exclude them altogether from new funds.

This Comment examines the particular problems that private equity funds face when judges or state attorneys general order investors and limited partners to disclose information that the securities laws normally allow to be kept private. Part I discusses the purpose and structure of the modern private equity fund and explains why privacy is so valuable to the funds. Part II describes how the Securities Act of 1933, the Investment Company Act of 1940, and the Investment Advisers Act of 1940 do not apply to private equity funds, and how this affects the disclosure requirements of these funds. Using various state statutes as illustrative examples, Part III discusses how FOIAs have altered the landscape of private equity investing. Part IV notes the inadequacy of a state-by-state approach to the amendment of FOIAs, and suggests that a national, uniform solution is more appropriate. Finally, Part IV proposes how such legislation might best be structured in order to reconcile the needs of both private equity firms and their public entity investors.

## I. THE STRUCTURE OF PRIVATE EQUITY FUNDS

Private equity funds are investment vehicles. Primarily accessible only to the wealthy and large institutions, they invest in a nondiversified portfolio of businesses to provide both investment capital and managerial expertise. These funds are attractive investments because they provide both high returns—an

4. The requested information varies greatly, from measures of investment performance such as fund internal rates of return (IRRs) to portfolio company valuations. For a discussion of IRRs, see *infra* note 101.

estimated 23.5 percent in 2004—and an opportunity for diversification not possible with other mainstream investments.[5]

Frequently, private equity funds are set up as limited partnerships or limited liability corporations.[6] In this arrangement, the private equity firm acts as the general partner or manager, and the investors in the fund, usually "a limited number of sophisticated investors,"[7] act as limited partners or members. To augment the capital contributions of these investors, the private equity firms make some kind of financial commitment to the fund, usually 1 percent of the total capital raised.[8] The total capital raised in any particular fund can exceed a billion dollars;[9] this is almost always invested in a portfolio of private companies with the intent to take the companies public, sell them, or liquidate them at a later date.[10] Because the general partner manages the day-to-day investing, the distribution of profits is usually 20 percent to the general partner (after management fees and expenses) and 80 percent to the limited partners.[11] Due to the work involved in managing the investment and advising portfolio companies, most private equity firms raise only a few funds.[12] The investments are not designed to be held indefinitely—most have a horizon of seven to thirteen years, with the investments liquidated or distributed to investors before the end of the fund's life.[13]

The privacy of fund information—including investor identity, amounts invested, capital structure of the fund, use of funds, financial statements of the firm, and expected return—is important to private equity firms for several reasons. First, certain investors do not want to be named because they do not wish to be known as investors in private equity. A company investing in private equity might, for example, wish to avoid having its identity known

5. *See* James Flanigan, *Billions Pour Into Private Equity*, L.A. TIMES, May 29, 2005, at C1.

6. *See generally* Jerry Borrell, *Work in Progress*, VENTURE CAP. J., Jan. 2004, at 26, 29 (discussing venture capital (VC) firm profit-splitting between the general partner and the limited partner).

7. JACK S. LEVIN, STRUCTURE VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS 10-2 (2003).

8. Borrell, *supra* note 6, at 29.

9. *See, e.g.*, Dan Primack, *False Alarm?*, VENTURE CAP. J., Sept. 2003, at 30, 34 (describing billion-dollar funds raised by NEA, CRV, and Accel).

10. LEVIN, *supra* note 7, at ¶ 103. *Cf. id.* ("[I]n the relatively infrequent cases where the investment is into a publicly-held company, VC generally holds non-public securities.").

11. LEVIN, *supra* note 7, at ¶ 102; Borrell, *supra* note 6, at 29.

12. For example, Sequoia Capital has been in business for over thirty years. Sequoia Capital, *Donald Valentine*, http://www.sequoiacap.com/scpartner.asp?pid=19 (last visited Oct. 3, 2004). In the most recent release by the University of California (UC) of its VC investments, the Regents revealed that UC was invested in Sequoia Capital's tenth fund (vintage year 2000). *See* The Regents of the University of California, *Alternative Investments as of March 31, 2003*, http://www.ucop.edu/treasurer/updates/PE%20irr.pdf (last visited Aug. 19, 2004).

13. LEVIN, *supra* note 7, at ¶ 103.

because of the high risk associated with such an investment strategy. Additionally, private equity investment signals to a company's own investors that alternative future business opportunities that could otherwise have been funded with the retained earnings have a lower expected rate of return than the private equity investment.[14]

Even if investor identity remains undisclosed, private equity firms do not want to disclose the amount contributed by different investors because this may reveal a perceived weakness about the firm to the market: exposure to idiosyncratic investor risk, for example, if the firm has only a handful of high-net-worth investors; or conversely, a dependency on many small investments from a large number of investors. Moreover, the number and contribution of investors reflect the firm's business strategy, which might well be considered a trade secret. A similar argument also may be made for favoring the nondisclosure of the firm's financial statements, capital structure, and ownership structure.

Finally, revealing specific details about how the funds are to be used, and their expected returns, is problematic. This is true because, in the case of private equity funds (as opposed to other companies making a public offering), the intent of the fund managers is to finance the portfolio companies with a limited set of investors and without attracting the interest of the general public. Revealing the identities of the portfolio companies therefore could have an adverse effect on those companies' relationships with customers and suppliers: The fact that a private equity company has invested conveys important information about, among other things, the management structure of the business and future business plans. For this reason, it is important to the success of the investment that as little public information as possible is revealed about the portfolio companies.

Because of this desire for privacy, a common feature of modern private equity funds is the nondisclosure agreement. Since their inception, partnership agreements establishing private equity funds have had confidentiality clauses.[15] Today, the agreements mostly mandate that investors receive the consent of the manager before disclosing any investment reports; alternatively, managers at least will request notification before investment reports are disclosed.[16] Most private equity funds and investors appear to agree that keeping invest-

14. Admittedly, only a small number of taxable corporations are private equity investors. Much more common are the pension funds and the educational institutions that are the focus of this Comment. The constituents of these institutions are usually aware or have the ability to determine that the institution is investing in private equity, though the particular fund may be undisclosed.

15. Borrell, *supra* note 6, at 33.

16. *Id.*

ment details confidential benefits all parties because "[limited partners] want to earn the best return possible and [general partners] want to safeguard sensitive information about the private companies in which they invest."[17]

Although nondisclosure agreements are important, it appears that their use and content varies widely among private equity firms. According to the chief attorney for the State of Wisconsin Investment Board, "[O]ne-third of the funds [the Board] has invested in didn't require it to sign a non-disclosure agreement."[18] Additionally, some nondisclosure agreements include a "carve out" that allows limited partners to disclose confidential information when they have a legal obligation to disclose it.[19] If such a clause is present, "[a]t a minimum, the fund will want to decide what information is going to be disclosed . . . to make sure the [limited partner] only discloses what it is absolutely obligated to disclose."[20]

These features of the modern private equity fund, while certainly not exhaustive, are sufficient to understand how federal statutes impact private equity funds.

## II. STATUTES GOVERNING PRIVATE EQUITY FIRMS AND FUNDS

Federal securities statutes, which would appear to regulate private equity funds, generally do not mandate disclosures from such funds. Even though limited partnership interests sold to investors by private equity firms are considered "securities,"[21] the Securities Act of 1933 does not govern the conduct of these private equity firms. Likewise, although private equity funds would appear to be investment companies within the meaning of the Investment Company Act of 1940,[22] and private equity firms would appear to be investment advisers under the Investment Advisers Act of 1940,[23] they are not. These firms and funds therefore escape mandated federal disclosure, placing the burden of requiring disclosure on the states via state FOIAs.

17. Mark Heesen, *Public Transparency Must Be Balanced With Protecting Private Data*, VENTURE CAP. J., Jan. 2003, at 44, 44.
18. Michael V. Copeland & Lawrence Aragon, *Ten Things to CYA*, VENTURE CAP. J., Dec. 2002, at 21, 21.
19. Danielle Fugazy, *Q&A: John Delaney and Jay Rand: Did You Check With Counsel? Attorneys Growing Role in VC*, VENTURE CAP. J., Jan. 2003, at 29, 31.
20. *Id.* at 32.
21. *See infra* Part II.A.
22. *See infra* Part II.B.
23. *See infra* Part II.C.

## A. The Securities Act of 1933

As discussed above, private equity funds are usually organized as limited partnerships. The Securities Act of 1933 includes in its definition of *security* a "certificate of interest or participation in any profit-sharing agreement" and an "investment contract."[24] A limited partnership interest is clearly included in this definition; however, there are certain securities transactions in which registration is exempted.

Registration under the Securities Act of 1933 entails making a large amount of information available to the public in the registration statement. Indeed, the registration statement discloses exactly the type of information that private equity firms historically have been reluctant to share, such as the names of certain investors,[25] the amount these investors have contributed,[26] information about the capital structure of the fund,[27] specific details about how the funds are to be used,[28] the expected return on the investment,[29] and financial statements of the private equity firm.[30] Thus, the firms substantially benefit by qualifying for one of the exemptions prescribed by the Act.

The major exception in the Securities Act is for a "transaction[ ] . . . not involving any public offering."[31] It is unclear from the text of the statute exactly what constitutes a nonpublic offering, also called a "private placement." In the only case on the issue heard by the Supreme Court, *SEC v. Ralston Purina Co.*,[32] Justice Clark's majority opinion described a private placement as "[a]n offering to those who are shown to be able to fend for themselves . . . 'not involving any public offering.'"[33] Justice Clark continued, "The focus of the inquiry should be on the need of the offerees for the protections afforded by registration."[34] Because private equity firms generally offer interests to large pension funds, universities, and other such sophisticated individual investors in order to take advantage of an exemption

24. 15 U.S.C. § 77b(a)(1) (2004).
25. *Id.* § 77aa(6).
26. *Id.* § 77aa(7).
27. *Id.* § 77aa(9)–(12).
28. *Id.* § 77aa(13).
29. *Id.* § 77aa(15). This is notoriously difficult to calculate in the arena of publicly traded equities, let alone in riskier venture capital startup investments.
30. *Id.* § 77aa(25)–(27).
31. *Id.* § 77d(2).
32. 346 U.S. 119 (1953).
33. *Id.* at 125.
34. *Id.* at 127.

in the Investment Company Act of 1940,[35] private equity transactions usually meet the limited offering standards described above.

Should the sale of limited partnership interests fail to qualify for the above exemption, the Securities Exchange Commission (SEC) has promulgated a series of safe harbor rules, collectively known as Regulation D.[36] Under Rule 506, a private equity firm can enter into a partnership with an unlimited number of "accredited investors"[37] and up to thirty-five additional investors who are "sophisticated" or who have a sophisticated purchaser representative.[38] Here, as above, most private equity funds are naturally composed of such investors. As such, they generally qualify for the Regulation D safe harbor.

### B. The Investment Company Act of 1940

The Investment Company Act of 1940 defines "investment company" as "any issuer [of a security] which is or holds itself out as being engaged primarily . . . in the business of investing, reinvesting, or trading in securities."[39] One might assume, then, that a private equity firm would be an investment company.[40] Yet, once again, such firms are usually exempt. Enacted not long after the stock market crash of 1929, and following the Securities Act of 1933 and the Securities Exchange Act of 1934, the purpose of this piece of legislation is "to eliminate the conditions . . . which adversely affect the national public interest and the interest of investors."[41] However, to allow for situations

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35. *See infra* Part II.B.

36. 17 C.F.R. §§ 230.501–.506 (2004). *See generally* Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355 (1984). Rules 504 and 505 are not generally useful in the context of private equity funds, as they are restricted to sales not exceeding $1 million and $5 million, respectively. 17 C.F.R. §§ 230.504–.505. However, Rule 506 contains no such limitation. *Id.* § 230.506.

37. Accredited investors include banks, savings and loans, and other institutional investors; ERISA plans; businesses and trusts with at least $5 million in assets; and high-net-worth individuals. *Id.* § 230.501(a).

38. *Id.* § 230.506(b)(2).

39. 15 U.S.C. § 80a-3(a)(1)(A) (2004). Recall that limited partnership interests issued by private equity firms are securities. *See supra* note 24 and accompanying text.

40. A private equity fund may characterize its business as engaging indirectly in the active business of the portfolio company, rather than as acting as an investment company. This argument fails because the SEC

> has taken the position that a holding company . . . which invests in "special situations" (i.e., acquires a controlling position in companies with the intent of reselling such securities at a profit after fixing or maturing the companies, rather than for the purpose of operating such companies' businesses for the long term) is an investment company.

LEVIN, *supra* note 7, at ¶ 1008(1) (citing 17 C.F.R. §270.3a-1(b)) (footnote omitted).

41. 15 U.S.C. § 80a-1(b).

in which excluding companies from the provisions of the Act would not harm investors or the national public interest, Congress created numerous exemptions. Companies qualifying for an exemption are not classified as "investment companies," which frees them from the requirements of the Act. Because registered investment companies are so heavily regulated,[42] private equity funds strive to ensure that they qualify for an exemption.[43] The two exemptions that private equity firms commonly utilize are the private investment fund exemption and the qualified purchaser fund exemption.[44]

The Investment Company Act excludes from its definition of *investment company* "any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons[45] and which is not making and does not presently propose to make a public offering of its securities."[46] A private equity fund that fits this description "escapes virtually all of the [Act]'s provisions."[47] Because private equity funds normally offer a private placement of their securities (the limited partnership or corporation interests) to a small number of investors,[48] they often will fit under this exemption.

The second exemption that a private equity fund may elect to take advantage of is the qualified purchaser exemption. A fund is not an investment company under the Act if its "outstanding securities . . . are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities."[49] Under the Act, a qualified purchaser is "any natural person . . . who owns not less than $5,000,000 in investments," or "any person . . . who in the aggregate owns and invests on a discretionary basis, not less than $25,000,000 in investments."[50] "Person," as defined in the

42. *See* LEVIN, *supra* note 7, at ¶ 1008(2) (describing the Investment Company Act's regulatory provisions as "onerous and impenetrable"). The Act's largest detriment is its limitation on the fees that a registered fund can receive, which essentially makes an exemption a dealbreaker for a fund.

43. *See id.* ("Only a handful of PE Funds have registered under the ICA.").

44. LEVIN, *supra* note 7, at ¶ 1008(3).

45. Each limited partner and general partner usually counts as a "beneficial owner," though there are numerous exceptions. For a detailed breakdown of the rules, see *id.* at ¶¶ 1008(4)–(5).

46. 15 U.S.C. § 80a-3(c)(1).

47. LEVIN, *supra* note 7, at ¶ 1008(4).

48. *See supra* note 8. Note that the offering must still be a private offering or else the private equity fund would have to register in accordance with the provisions of the Securities Act of 1933. LEVIN, *supra* note 7, at ¶ 1009.

49. 15 U.S.C. § 80a-3(c)(7)(A).

50. *Id.* § 80a-2(a)(51)(A)(i), § 80a-2(a)(51)(A)(iv). In addition to individual investors, trusts, married couples, or family-owned businesses may also be qualified purchasers. *See generally id.* § 80a-2(a)(51).

Act, "means a natural person or a company."[51] "Investments" are defined by SEC regulations: "[I]nvestments are broader than securities, but not every asset is an investment."[52] The very decision to include a qualified purchaser exemption suggests a desire to protect only those investors who need protection; thus, "[t]o constitute an investment, an asset must be held for investment purposes, and the nature of the asset must indicate a significant degree of investment experience and sophistication such that the investor can be expected to have the knowledge to evaluate the risks of investing in unregulated investment pools."[53]

A private equity firm that is exempted from the provisions of the Investment Company Act is not subject to the Act's disclosure and reporting requirements.[54] Investment companies must file a registration statement with the SEC containing its policies on, among other things, underwriting other companies' securities, borrowing and lending, issuing senior securities, investing in particular industries, buying and selling real estate and commodities, and portfolio turnover.[55] Additionally, the investment company must file any information necessary under the Securities Act of 1933 and the Securities Exchange Act of 1934 to register the company's securities or proposed securities.[56] These registration documents are available for public viewing unless the SEC determines that limiting disclosure protects investors or does not harm the public interest.[57]

Besides registration documents filed with the SEC, investment companies must file annual reports pursuant to section 13(a) of the Securities Exchange Act of 1934, which are available for public examination.[58] They must also give semiannual reports to stockholders, which contain: a balance sheet showing the aggregate value of investments; a list detailing the amounts and values of securities owned; an income statement; a statement of surplus; a statement

51. *Id.* § 80a-2(a)(28).

52. LEVIN, *supra* note 7, at ¶ 1008(6).

53. *Id.* SEC regulations state that investments include securities and real estate, commodities, cash and cash equivalents, and financial contracts held for investment purposes. 17 C.F.R. § 270.2a51-1 (2004).

54. Investment companies have innumerable other limitations placed on them by the Act. They are restricted in the investing activities they may pursue, cannot purchase on margin, cannot short sell almost any security, often cannot self-distribute their own securities, and may not have underwriting commitments exceeding 25 percent of the company's total asset value. 15 U.S.C. § 80a-12. Investment companies also are limited in capital structure by the inability to issue senior securities, warrants, and subscriptions rights. *Id.* § 80a-18. Furthermore, they are restricted in some circumstances from distributing dividends and capital gains to their investors. *Id.* § 80a-19.

55. *Id.* § 80a-8(b)(1).

56. *Id.* § 80a-8(b)(5).

57. *Id.* § 80a-44(a).

58. *Id.* § 80a-29(a).

showing remuneration paid to officers and directors; and a statement of the aggregate dollar amounts of purchases and sales of investment securities.[59] Because of these required disclosures, the returns on a company's investments are disclosed directly to the public or are readily calculable by simply comparing the value of securities presently owned to the same values in the previous report.

### C. The Investment Advisers Act of 1940

Private equity firms also escape regulation under the Investment Advisers Act of 1940. As defined in the Act, an investment adviser is "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities."[60] The private equity firm, in recruiting its limited partners and advising its portfolio companies, clearly acts in this role.[61]

Under the Act, such an investment adviser must register itself unless it qualifies for an exemption.[62] Like the statutes previously discussed, a private equity firm usually can exempt itself: The exemption most frequently used by private equity firms is the "fewer than fifteen clients exemption." The Act provides such an exemption from registration if "during the course of the preceding twelve months [an investment advisor] has had fewer than fifteen clients and . . . neither holds [itself] out generally to the public as an investment adviser nor acts as an investment adviser to any investment company" registered under the Act.[63]

What counts as a single advisory client under the meaning of the Act? When the private equity firm is the general partner of multiple funds, "each such fund will generally be a separate advisory client."[64] There are circumstances in which each limited partner may be treated as an advisory client.[65] However, an SEC safe harbor rule counts only the fund as a client and not the limited partners so long as the general partner provides to the fund "investment advice based on its investment objectives rather than the indi-

59. *Id.* § 80a-29(e).

60. *Id.* § 80b-2(a)(11).

61. 17 C.F.R. § 275.203(b)(3)–1(a)(2)(i) (2004).

62. 15 U.S.C. § 80b-3(b).

63. *Id.* § 80b-3(b)(3); *see also* LEVIN, *supra* note 7, at ¶ 1010(4) (stating that for the general partner to "effectively use the . . . exemption, the PE Fund must be located in a state with favorable state blue sky investment adviser licensing requirements").

64. LEVIN, *supra* note 7, at ¶ 1010(5)(a).

65. As of February 2005, each investor in a private fund counts as a client for the purposes of determining whether the fund qualifies for the exception. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,070 (Dec. 10, 2004), *available at* http://www.sec.gov/rules/final/ia-2333.pdf.

vidual investment objectives of its shareholders, partners, limited partners, members, or beneficiaries."[66] As described in Part I, most (if not all) private equity firms have a limited number of funds to invest in, and because of the relative infrequency with which these funds are raised, a single private equity firm rarely will have fifteen funds active in any one year. Therefore, most private equity firms qualify for this exemption.

Being exempted from the definition of "investment adviser" has several benefits similar to those of being exempted under the Investment Company Act of 1940. Exempted private equity firms need not register under the Act, meaning they need not disclose financial statements or the basis for adviser's compensation, among other things.[67] Because they also do not have to keep records defined by section 3(a)(37) of the Securities Exchange Act of 1934,[68] this information is not available to the public, as it would be if the private equity fund were required to disclose it.[69]

## III. THE EFFECT OF FREEDOM OF INFORMATION ACTS (FOIAS)

### A. State Freedom of Information Acts

Private equity firms are generally able to avoid disclosing investment information under federal securities law. However, in recent years, various groups have used state Freedom of Information Acts (FOIAs) to demand scrutiny of private equity firms' most prominent investors: public institutions and entities. This scrutiny, of course, also extends to the entities' investments. In various recent lawsuits brought under state FOIAs targeting the private equity investments of public institutions,[70] the complaining parties have found judges willing to mandate disclosure of this type of investment information.[71]

66. 17 C.F.R. § 275.203(b)(3)–1(a)(2)(i). This is true as long as the limited partner does not receive separate investment advice from the general partner. LEVIN, *supra* note 7, at ¶ 1010(5)(b)(ii).

67. *See* 15 U.S.C. § 80b-3(c)(1).

68. *Id.* § 80b-4.

69. *Id.* § 80b-10(a). However, it is important to note that "the identity, investments, or affairs" of a fund's clients are not available for public consumption. *Id.* § 80b-10(c). Thus, it is unclear exactly what portfolio information would be publicly available under this Act—since the clients are the funds themselves, the Act cannot force a private equity firm to disclose the identity of its portfolio companies or its affairs. Nevertheless, requiring disclosure of financial statements releases information about the return on investments to the firm, including the aggregate returns of individual funds.

70. *See infra* Part III.B.

71. This does not suggest that the judges are doing anything improper. The point intended is that this is a recently developed area of the law, and in the cases where courts have required disclosure, they conceivably could have ruled either way given the lack of precedent. *See infra* Part III.B.

This altered landscape could have a dramatic effect on the relationship between public institutions and private equity firms. All fifty states have FOIAs that, aside from minor variances, closely mirror the federal FOIA in structure and content.[72] For this reason, this part discusses a sample of six representative state statutes: the FOIAs enacted in California, Colorado, Illinois, Massachusetts, Michigan, and Virginia.[73]

Most state FOIA statutes begin with legislative findings describing the necessity of enacting the legislation. Two common and intertwined themes frequently appear in these sections: transparency in government and the accountability of government to its constituents. For example, California's FOIA states that "access to information concerning the conduct of the people's business is a fundamental and necessary right of every person in this state."[74] Virginia's similarly declares that "[t]he affairs of government are not intended to be conducted in an atmosphere of secrecy since at all times the public is to be the beneficiary of any action taken at any level of government."[75] In defining the "public" that is to be given access to public records, some states include "every person,"[76] while others only include citizens of the state.[77]

The six illustrative statutes contain relatively uniform definitions of the types of records subject to disclosure. They are generally wide reaching, if somewhat vague, in allowing the public to view records.[78] Michigan's statute is broad, encompassing any "writing prepared, owned, used, in the possession of, or retained by a public body in the performance of an official function."[79] Virginia's FOIA likewise refers to writings in "the transaction of public business."[80] Other states explicitly refer to the use of public funds: Colorado's law allows access to

72. *See* Lawrence Aragon, *From the Editor: Don't Take Money From Strangers*, VENTURE CAP. J., Nov. 2002, at 2, 2 ("[E]ach state had its own separate FOIA . . . ."); Michael V. Copeland, *Hurricane FOIA Slams Public Pension Funds*, VENTURE CAP. J., Dec. 2002, at 5, 5. The Massachusetts statute is the exception to the rule. Instead of phrasing the right as one of access to records, it is presented as a directive to the holders of the records. *See* MASS. ANN. LAWS ch. 66, § 1, 10 (LexisNexis 2002 & Supp. 2005).

73. Statutes from California, Colorado, Illinois, Massachusetts, Michigan, and Virginia are used in this section for several reasons. First, they represent a geographically diverse area. Second, Massachusetts and California are states in which venture capital firms are frequently located and where many of their investors are headquartered. Third, many of these states have enacted amendments to their FOIAs that will be useful for discussion in Part III.C.3.

74. CAL. GOV'T CODE § 6250 (West 1995 & Supp. 2005).

75. VA. CODE ANN. § 2.2-3700(B) (2001 & Supp. 2004).

76. *See* CAL. GOV'T CODE § 6253(a).

77. *See, e.g.*, VA. CODE ANN. § 2.2-3704(A).

78. Most statutes use the term "writing." The statutory definition is usually so broad as to encompass anything tangible. Colorado's statute, for example, refers to "documentary materials, regardless of physical form or characteristics." COLO. REV. STAT. § 24-72-202(7) (2004).

79. MICH. COMP. LAWS ANN. § 15.232(e) (West 2004 & Supp. 2005).

80. VA. CODE ANN. § 2.2-3701.

records "involving the receipt or expenditure of public funds,"[81] and Illinois's statute includes "all information in any account, voucher, or contract dealing with the receipt or expenditure of public or other funds of public bodies."[82]

These FOIAs then define which public agencies and institutions are affected by the legislation—in definitional sections that often are sweeping lists of government agencies. California's agencies include "every state office, officer, department, division, bureau, board, and commission,"[83] as well as any "county; city, whether general law or chartered; city and county; school district; municipal corporation; district; [and] political subdivision."[84] In addition to these lists, other states have general provisions for any "body in the executive branch of the state government" or one that is "created by state or local authority or which is primarily funded by or through state or local authority."[85] Virginia's statute is similar in its level of specificity, but it also refers to "[c]orporations organized by the Virginia Retirement System" as "public bodies."[86]

Indeed, several states have made public retirement systems and public universities subject to the provisions of their FOIAs. California included its Public Employees' Retirement System and Teachers' Retirement Board in its FOIA;[87] Colorado included the University of Colorado and its regents;[88] and Virginia included the University of Virginia in addition to the Virginia Retirement System.[89] Critically, states oftentimes do not exempt such public institutions' financial information from FOIA disclosure, and yet it is not apparent that the states appropriately considered the impact of including investment information subject to confidentiality agreements.[90] In fact, many of these states have

81. COLO. REV. STAT. § 24-72-202(6)(a)(I).

82. 5 ILL. COMP. STAT. ANN. 140/2(c)(vii) (West 1993 & Supp. 2005).

83. CAL. GOV'T CODE § 6252(f) (West 1995 & Supp. 2005).

84. *Id.* § 6252(a).

85. MICH. COMP. LAWS ANN. §§ 15.232(d)(i), 15.232(d)(iv) (West 2004 & Supp. 2005).

86. VA. CODE ANN. § 2.2-3701 (2001 & Supp. 2004).

87. CAL. GOV'T CODE § 6253.4(a). A FOIA request for private equity returns of CalPERS ultimately became the subject of a lawsuit. *See infra* Part III.B.1.

88. COLO. REV. STAT. § 24-72-202(1.5) (2004).

89. VA. CODE ANN. § 2.2-3705(47) (repealed 2004).

90. *See, e.g.*, *id.* § 2.2-3705(20) (exempting "[d]ata, records or information of a proprietary nature produced or collected by or for faculty or staff of public institutions of higher education, other than the institutions' financial or administrative records"). In some states, this issue was addressed by Attorney General opinion and not by statute. *See, e.g.*, 1997–1980 Mich. Op. Att'y Gen. 255 (1979) (stating that information contained in internal audits concerning a department of a university are not exempt from disclosure, because the state constitution provides that all financial records, accountings, audit records, and other reports of public money or public records are open to inspection).

recently amended their FOIAs or are considering amending them in response to the private equity cases.[91]

Some statutes applicable to public institutions do exempt certain "confidential" information from disclosure.[92] For this exemption to apply, the information "must be: (a) a 'trade secret' or 'commercial' or 'financial' information; (b) 'obtained from a person;' and/or (c) 'privileged' or 'confidential.'"[93] Notably, courts apply a two-part test to determine whether the documents are confidential: (1) "whether disclosure is likely to . . . impair the government's ability to obtain necessary information in the future," and (2) whether disclosure will "cause substantial harm to the competitive position of the person from whom the information was obtained."[94] Because only the government is likely to initiate the first prong, venture funds or their investors are more likely to focus on the second.[95] Here, courts attempt to strike a balance "between the strong public interest in favor of disclosure of information and the rights of those submitting information to privacy and confidentiality."[96] Courts generally have found that a showing of actual harm is not necessary; showing "the likelihood of substantial competitive injury" from disclosure to the general public is sufficient.[97]

A less stringent test, however, is sometimes applied when information is voluntarily disclosed by the originator of the information (the private equity firm) to the party from whom the information is requested (the public investor). Voluntarily disclosed information is considered confidential when "it is of a kind that the provider would not customarily release to the public."[98] Private equity fund returns meet this standard because the whole idea of private

91. *See infra* Part III.C.3.

92. *See, e.g.*, CAL. GOV'T CODE § 6254.15 (West 1995 & Supp. 2005) ("Nothing in this chapter shall be construed to require the disclosure of . . . corporate financial records, corporate proprietary information including trade secrets . . . ."); COLO. REV. STAT. § 24-72-204(3)(a)(IV) (exempting "[t]rade secrets, privileged information, and confidential commercial, [and] financial . . . data"); 5 ILL. COMP. STAT. ANN. 140/7(1)(g) (West 1993 & Supp. 2005) (exempting "[t]rade secrets and commercial or financial information obtained from a person or business where the trade secrets or information are proprietary, privileged or confidential, or where disclosure of the trade secrets or information may cause competitive harm"). California additionally has an exemption for nondisclosure when it is in the public interest. CAL. GOV'T CODE § 6255(a) ("The agency shall justify withholding any record by demonstrating that . . . on the facts of the particular case the public interest served by not disclosing the record clearly outweighs the public interest served by disclosure of the record.").

93. Todd Boudreau, *How to Protect Confidential Info in Light of UTIMCO*, VENTURE CAP. J., Nov. 2002, at 28, 28.

94. *Id.*

95. *Id.* at 28–29.

96. *Id.* at 29.

97. *Id.*

98. *Id.*

equity is to keep such information from the public. The application of this type of confidentiality exception varies from state to state; Wisconsin will not disclose information covered by a confidentiality agreement, but Texas will.[99] Thus, the availability of a confidentiality exception is far from uniform, and the absence of a provision protecting confidential information can lead to litigation demanding disclosure.

### B. Disclosure Cases and Attorneys General Directives

Public interest in private equity investment returns appears to have arisen when Ross Perot ran for president in 1992.[100] Since that time, requests of institutions to disclose such returns have met with substantial opposition. This has occurred in the context of public university and public pension fund investments, most notably in California, Texas, and Michigan.

#### 1. The University of Michigan

Until recently, Michigan's FOIA required disclosure of investments made with public money. Faced with a disclosure request for data about its private equity portfolio, the University of Michigan complied with the request, disclosing the value of its funds in March 2003, including internal rate of return (IRR) data.[101] Sequoia Capital, one of the firms whose fund data was released by the University, informed the University that it did not want any future disclosures.[102] Facing pressure from the fund, the University refused to disclose whether or not it was an investor in Sequoia Capital XI,[103] though the University ultimately revealed that it had been accepted into the fund.[104]

Although the University had invested in six Sequoia funds since 1992, in July 2003 Sequoia expelled it from the Sequoia Capital XI fund and asked

99. Lawrence Aragon, *Disclosure*, VENTURE CAP. J., Nov. 2002, at 20, 20.

100. Susan Chaplinksy & Susan Perry, CalPERS vs. Mercury News: *Disclosure Comes to Private Equity* 1 (2004) (unpublished case study, on file with author) (noting that "[Perot's] federal election filing included 250 investments in various private-equity funds").

101. Carolina Braunschweig & Dan Primack, *Data Bank*, VENTURE CAP. J., Apr. 2003, at 57, 57. IRR is an important concept in investing. Although IRR calculation methods vary widely, see *infra* note 218, the IRR is the interest rate that makes the net present value of all future cash flows equal to zero. It is essentially a measure of fund self-performance. *See* Investopedia.com, Internal Rate of Return, http://www.investopedia.com/terms/i/irr.asp (last visited Aug. 29, 2005).

102. Lawrence Aragon, *New Sequoia Fund Stirs Speculation*, VENTURE CAP. J., Apr. 2003, at 13, 13.

103. *Id.*

104. Dan Primack, *Michigan Changes Disclosure Law to Protect PE Data*, VENTURE CAP. J., June 2004, at 16, 16.

it to leave several other funds.[105] Citing concerns about "people who hope to profit from the sale of data about the venture capital business and newspapers interested in publishing articles about [the] business,"[106] Sequoia terminated its relationship with the University. To prevent similar treatment of the University by other private equity firms, Michigan recently amended its law to exempt private equity firms from disclosure requirements under the state FOIA.[107]

2. The University of California (UC) and the California Public Employees' Retirement System (CalPERS)

In October 2002, the *San Jose Mercury News* filed an action against CalPERS to disclose information under California's Public Records Act.[108] The newspaper sought the release of "all reports showing the performance of private equity investments made under CalPERS Alternative Investment (AIM) Program,"[109] which includes fund-level IRRs, cash-in/cash-out data,[110] and fiscal data on the underlying assets.[111]

In response, the National Venture Capital Association (NVCA) submitted a memorandum to CalPERS asserting that the release of this information would be harmful to the venture capital industry.[112] Backed by the trade association, CalPERS decided to fight the request rather than turn over the information, and it argued for trade secret protection for both fund and underlying asset information.[113]

Judge James Robertson tentatively refused to classify fund information as a trade secret. In his November 2002 preliminary ruling, he established a fact-finding mechanism to determine what CalPERS had to disclose.[114] In the ruling, he determined that the identity and valuations of portfolio companies are trade secrets not subject to disclosure.[115] He required the various private equity funds to certify by December 2002 that they had not disclosed this

105. Lawrence Aragon, *Sequoia's Decision to Boot Wolverines May Change IRR Ruling*, PRIVATE EQUITY WK., Aug. 11, 2003, *available at* LEXIS, PRIVEQ File; John Shinal, *UC Ordered to Reveal Details of Investments*, S.F. CHRON., Aug. 29, 2003, at A1.

106. Aragon, *supra* note 105, at 1.

107. *See infra* Part III.C.3.

108. Dan Primack, *2002 In Review: The Playing Field Gets Leveled*, VENTURE CAP. J., Feb. 2003, at 3, 6.

109. Heesen, *supra* note 17, at 44.

110. Cash-in/cash-out data is the most basic type of investment data an investor can provide. It is the amount of cash invested versus the amount of money returned at the end of the investment period.

111. Primack, *supra* note 108, at 6.

112. Heesen, *supra* note 17, at 44. NVCA also filed an amicus brief in the suit. *Id.*

113. Primack, *supra* note 108, at 6.

114. Heesen, *supra* note 17, at 44.

115. *Id.*

information, except confidentially to partners.[116] He also ruled that IRRs are presumptively not trade secrets, but gave the private equity companies the opportunity to offer evidence in rebuttal. To prevail, the court required the companies to show why IRRs should be considered trade secrets, as well as their economic value to the fund.[117] Rather than continue to fight, CalPERS complied with the request and released the data.[118] However, it continued to withhold more than 150 investments made through the third-party placement group Grove Street Advisors.[119]

Fueled by its success against CalPERS, on December 24, 2002, the *San Jose Mercury News* joined with the Coalition of University Employees and retired University of California (UC) professor Charles Schwartz to request private equity data from the UC.[120] The request under California's Public Records Act was for "all documents showing the internal rate of return of any private equity investments which have been made by the University of California."[121] After UC failed to comply with the request, the requesters sued on April 1, 2003,[122] demanding "all reports, documents and other public records showing the performance of private equity investments made by UC, including but not limited to documents showing the internal rate of return."[123]

On July 24, 2003, the Alameda County Superior Court ordered the UC Regents to disclose fund-level IRRs for ninety-four private equity investments under the California Public Records Act, but it did not order the disclosure of underlying asset values.[124] Judge James Richman predicated much of his decision on the fact that the University of Michigan did not suffer repercussions from being forced to disclose IRRs of private equity investments;

116. *Id.*

117. *Id.*

118. Daniel Gross, *Take Your Money and Leave*, SLATE MAG., Sept. 17, 2003, http://slate.msn.com/id/2088544. The data is available online. *See* CalPERS, AIM Program Fund Performance Review, *at* http://www.calpers.ca.gov/index.jsp?bc=/investments/assets/equities/aim/private-equity-review/aim-perform-review/home.xml (last visited Aug. 9, 2004).

119. Mairin Burns, *Open Up: Investors Are Forcing Changes on the Once-Shrouded World of Private Equity*, INVESTMENT DEALERS' DIG., Oct. 20, 2003, at 24, 27.

120. Lawrence Aragon & Daniel Primack, *UC Loses Appeal, Then Digs in Its Heels*, PRIVATE EQUITY WK., Oct. 6, 2003, at 1, 14.

121. *Id.* (quoting Coalition of Univ. Employees v. Regents of the Univ. of Cal., No. RGO3-089302, 2003 WL22717384, at *1 (Cal. Super. Ct. July 24, 2003)).

122. *Coalition of Univ..Employees*, 2003 WL 22717384, at *1; Aragon & Primack, *supra* note 120, at 14.

123. Aragon & Primack, *supra* note 120, at 14 (quoting Petition for Writ of Mandate to Compel Release of Public Records 7, Coalition of Univ. Employees v. Regents of the Univ. of Cal., No. RG03-089302, 2003 WL 22717384 (Cal. Super. Ct. July 24, 2003)).

124. *Coalition of Univ. Employees*, 2003 WL 22717384, at *9; Lawrence Aragon, *UC Relents, Gives up PE Performance Data*, VENTURE CAP. J., Nov. 2003, at 6, 6; Primack, *supra* note 108, at 6.

but, on the same day, it was revealed that Sequoia Capital had kicked the University of Michigan out of its XI fund.[125] Even with this new information, Judge Richman refused to reconsider his ruling.[126]

On September 5, UC appealed and revealed that it, too, was dropped from the same Sequoia fund in the same manner.[127] The California Supreme Court rejected this appeal on September 30.[128] In response, UC released fund-level IRRs on October 3—which were over fifteen months old—but no other information, including vintage years.[129] The same parties immediately sued for cash-in/cash-out data,[130] accusing UC of violating the spirit of the court order.[131] UC complied on October 16 but took longer to electronically publish the data on its website, which they had been ordered to do.[132] In January 2004, the California Supreme Court denied review of the case and an application for a stay of the ruling, putting the issue temporarily to rest.[133]

Industry observers worried about the impact of the court-mandated disclosure, especially given Sequoia's rapid reaction. Private equity firm MPM allowed CalPERS into its $900 million BioVentures III fund in December 2002, but some speculate that this was motivated by MPM's desire to raise a large fund.[134] According to MPM, it is "not so concerned with [its] IRR being released"; rather, its biggest concern is that private company information remains private.[135] Thus, it remains uncertain what the long-term impact of the California decision will be.

### 3. The University of Texas Investment Management Company (UTIMCO)

In 1996, the *Houston Chronicle* published an article concerning possible impropriety between UTIMCO, the investment vehicle for the University of Texas endowment, and Austin Ventures, a Texas venture capital fund in

125. Aragon, *supra* note 124, at 14; *see infra* Part III.A.3.
126. *Id.*
127. Aragon & Primack, *supra* note 120, at 15. Sequoia also asked UC to unload its investments in other funds, but reportedly has not pursued the request. Ann Grimes, *Disclosure Dilemma: Their Secretive Ways at Stake, Venture Firms Cut off Investors*, WALL ST. J., May 11, 2004, at A1.
128. Aragon & Primack, *supra* note 120, at 15.
129. Aragon, *supra* note 124, at 6.
130. *See supra* note 110.
131. Aragon, *supra* note 124, at 6.
132. *Id.*
133. Regents of the Univ. of Cal. v. Coalition of Univ. Employees, No. S121761, 2004 Cal. LEXIS 400 (Jan. 12, 2004).
134. Aragon, *supra* note 102, at 13.
135. Danielle Fugazy, *MPM Nails Year's Biggest Venture Fund*, VENTURE CAP. J., Feb. 2003, at 15, 15.

which UTIMCO had invested.[136] Tom Hicks was both a University of Texas regent and a partner in Austin Ventures, and speculation arose that "investment managers were improperly influenced in directing endowment funds to Austin Ventures."[137]

UTIMCO rebuffed disclosure requests until October 2003, when a *Houston Chronicle* reporter filed a FOIA request for fund-by-fund performance data on all funds in the UTIMCO private equity portfolio.[138] Although UTIMCO had confidentiality agreements with all its general partners, the Texas FOIA superseded these agreements.[139] At the urging of then-Attorney General John Cornyn, UTIMCO chose disclosure over litigation and released data for IRR, fund name, fund manager, vintage year,[140] general partner's assessment of current investment value, commitment, and cash-in/cash-out for $1.8 billion of private equity fund investments on September 18, 2003.[141] UTIMCO did not release all the data requested, however. Specifically, it refused to release the limited partnership agreements after the Attorney General directed UTIMCO to refrain from disclosing the agreements in their entirety, citing concerns that their disclosure would lead to "substantial competitive harm" to UTIMCO.[142]

After the release of the data, UTIMCO's general partners had the option to sue or submit their position on the Attorney General's directive in order to demonstrate how they would suffer "substantial competitive injury."[143] Litigation would have been difficult, however, because most of the limited partnership agreements contained a general exclusion for the release of information at the request of a government agency.[144] Also, the general partners did not want to be perceived by potential investors as litigious business partners.[145] Therefore, the partners did not attempt to block the disclosure, and interestingly, none of the venture funds submitted information either. This may have occurred because substantial competitive injury would be incredibly difficult to prove, and in fact, it may have been impossible to show *any* competitive injury. Since all private equity firms doing business with

136. Chaplinksy & Perry, *supra* note 100, at 1.
137. *Id.*
138. Primack, *supra* note 108, at 6.
139. *Id.*
140. That is, the year the fund was raised. *See* TIFF Education Foundation, Glossary of Terms, *at* http://www.tiff.org/TEF/glossary/vintage.html (last visited Aug. 30, 2005).
141. *Id.*
142. Heesen, *supra* note 17, at 44.
143. Boudreau, *supra* note 93, at 29.
144. *Id.* at 28.
145. *Id.*

UTIMCO money were subject to the same directive, they all were affected equally and there were no competitive consequences.[146]

The ultimate result of these events is that UTIMCO will no longer invest with private equity firms that refuse to disclose certain data, including IRRs.[147] Although the reporter seeking disclosure initially had suspected improper associations between fund managers and political figures,[148] no political connections or self-dealing were ultimately uncovered.[149]

### C. Results of Disclosure

As a consequence of private equity returns being released to the general public, some parties have benefited at the expense of others. Because the above controversies only have been resolved recently, this subpart will focus on the short-term effects of requiring disclosure.[150]

#### 1. Parties Benefited

The transparency in government that FOIAs provide the public is undoubtedly a benefit of disclosure. This transparency increases the accountability of the state and provides an incentive for it to invest public money wisely, as the successes and failures of investments are publicized. The benefit of transparency in government is combined with the benefit of public availability of firm and industry information. Indeed, this is the very reason FOIAs were enacted in most jurisdictions, and there are many benefits associated with such disclosure, including providing "valuable information about the firm and the industry in which it operates" and promoting competition by allowing competitors and investors in other firms access to information.[151] Perhaps

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146. Private equity firms doing business with UTIMCO may still have been harmed in relation to private equity firms not subject to the directive, which could view their disclosed fund information. However, it seems more likely that the information released, which did not include underlying asset names or values, was high-level enough that no harm was caused.

147. Ann Grimes, *Venture Funds' Best-Kept Secret*, WALL ST. J., May 27, 2004, at C1.

148. Dan Primack, *Embattled UTIMCO Chief Tells His Side of the Story*, VENTURE CAP. J., Nov. 2002, at 26, 26–27.

149. Primack, *supra* note 108, at 6.

150. It is not easy to describe these effects empirically. There is a shortage of studies on the issue, as it has occurred so recently, and there may be many factors at play in the venture capital arena besides state FOIA statutes. Thus, the discussion in the following paragraphs is limited to general, intuitive concepts.

151. Uri Geiger, *The Case for the Harmonization of Securities Disclosure Rules in the Global Market*, 1997 COLUM. BUS. L. REV. 241, 295–97 (suggesting that the benefits of disclosure cannot be captured without regulation because of the free-rider problem in the context of public disclosure of securities information). *Cf.* Richard L. Huff, *A Preliminary Analysis of the*

for this reason, academic literature discussing FOIA benefits outside of the private equity context often cites consumer awareness as a benefit.[152] A parallel may be drawn between safety concerns in consumer goods and an investment in private equity. The public may use the investment data to identify alternative investment opportunities in funds with a higher historical return, or funds with less variance, and it may demand changes to the institutional investments.[153] To analogize to the health care public disclosure movement, providing the public with data on fund returns will increase investors' ability to make an informed decision—"but only if the data are timely, accurate, understandable and well-presented."[154] Disclosure also may cut costs (such as fund management fees) through increased competition among funds for public money.[155] If lowering costs does not decrease investment returns, cost cutting is beneficial to public investors. Finally, disclosure may eliminate poor performers because fewer investors will be willing to invest in historically poor performing funds.[156]

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*Implementation of the Freedom of Information Reform Act of 1986*, 1989 ARMY LAW. 7, 12–13. In a somewhat similar situation, the U.S. Army addressed criteria influencing whether or not to release information in compliance with a FOIA request. In addition to factors previously discussed, the report addressed unique factors, including suspicion of a party's possible commercial interests, and contribution to the public knowledge. Interestingly, factors considered included the public's ability to understand the information and the overall contribution to the public knowledge. *Id.* at 12. In the private equity context, there is the converse concern that the public (not including sophisticated investors) will not understand the incomparability of IRRs across firms or the J-curve phenomenon. This concern, however, is not taken into account in a private equity FOIA request. For a further discussion of the J-curve phenomenon, see *infra* note 180 and accompanying text.

152. *See, e.g.*, Margaret Witherup Tindall, *Breast Implant Information as Trade Secrets: Another Look at FOIA's Fourth Exemption*, 7 ADMIN. L.J. AM. U. 213, 231–32 (1993) (discussing consumer awareness of health and safety issues with respect to breast implants).

153. Note, however, that historical data may not be useful for predicting the future investment opportunities of any particular firm. Each fund is based on different underlying portfolio companies and thus is subject to idiosyncratic risks. The limited universe of portfolio companies guarantees that this risk will not be fully diversified. This risk is the reason for high expected returns in PE investments. In evaluating potential investment alternatives, taking the risk-reward tradeoff into account simply is not sufficient because of restrictions on the ability of public money to support certain types of activities. For example, some states do not allow private equity investments based on "public morals," including investments in tobacco companies.

154. Douglas Sharrott, Note, *Provider-Specific Quality-of-Care Data: A Proposal for Limited Mandatory Disclosure*, 58 BROOK. L. REV. 85, 120–23 (1992). The presentation of data is a constant concern for reporting private equity returns. Recall the UC case, *supra* notes 127–133 and accompanying text, in which UC released only data from fifteen months prior. The discrepancy between different IRR computation methods also contributes to confusion.

155. Sharrott, *supra* note 154, at 125–26.

156. *See id.* at 124–25. Note that this only applies to new investors because current investors already know how their investments are performing when it comes time to cash out. It is unclear whether this information will benefit new investors because, generally, they receive some information about prior fund performance to entice investment.

Additionally, some may argue that public institutions are benefited by FOIAs because the acts create an additional obligation of reporting investment returns on request. Public scrutiny places additional pressure on the institutions and their investment managers, which perhaps helps to align the institutions' investing activities with the public interest. Ideally, this right of inspection should not be necessary since the funds are being managed for the public good (specifically, the good of their constituents), regardless of the existence of a FOIA. However, this ideal world assumes no agency costs, full compliance with fiduciary duties, no self-dealing, and no shirking—all assumptions useful in economic modeling but which are rarely present in the real world. For example, institutional managers may direct funds under their management to private equity firms that employ their friends or acquaintances, or in which they may have a personal stake; managers may employ a random method of fund selection; or managers may pursue any number of activities that deviate from the ideal manager who performs his duties with diligence solely in the best interests of his beneficiaries. As a practical matter, FOIAs also may not provide adequate oversight or monitoring to reduce these agency costs, as a result of the free-rider problem. The public institution presents a twist on the classic free-rider model because there are no large stakeholders with the incentive to monitor the managers to protect their own interests. Presumably, in pension funds, a single person's interest is roughly equal to that of other stakeholders. Therefore, they have roughly equivalent disincentives to incur the expense of monitoring.

It may be, however, that this *potential* for monitoring incentivizes managers to act in the best interests of their constituents. Consequently, the primary benefit is intangible: The public institution will benefit from increased public confidence in its investments and investing strategies. This public confidence is conditioned on two main factors. First, the public must be aware of the existence of a FOIA to have confidence in it. Second, the investment strategies should have some successes, although the requisite level of success is difficult to determine. The public as a whole, most likely, is ill-equipped to determine what returns private equity investments should generate.[157] However, for much of the public, a failure to generate sufficient rates of return may be perceived as a failure of the monitoring process, rather than a function of market or portfolio volatility. Sophisticated investors probably

157. The public could rely on private equity industry professionals for this information, however, if it were publicized. The volatility of any one portfolio makes forecasting expected returns extremely difficult, if not impossible.

can perceive the difference, but the average citizen may be unable to make this distinction.

Aside from the benefits accrued to the general public from the free flow of information, a few other parties also stand to gain from the release of private equity funds' investment data. One party that particularly benefits is venture capital data resellers.[158] These parties acquire data, organize and mine it, and sell it to investors looking for a numerical basis for investment decisions. Being able to acquire information nearly free of charge through FOIAs immeasurably benefits their business. However, it is unclear whether they resell only IRR data, or information about the underlying asset values of the portfolio companies as well. Since the underlying asset values are rarely released, if ever, this information is still costly to obtain.

Another group that may benefit from open disclosure is young private equity funds. Without the history of the established industry players' good returns, these firms are often willing to make sacrifices, such as releasing fund information, to entice large investors.[159] Thus, to the extent that disclosure causes public money to be locked out of other funds, these startup funds may see an influx of public partners.

Finally, foreign investors may benefit unexpectedly from state FOIAs. Because foreign investors are not subject to any FOIAs, private equity funds recently have experienced an influx of foreign capital, especially from Europe.[160] As U.S. public institutions become less desirable investors, foreign money with fewer strings attached may become more attractive to private equity firms that have had no room for such investors in the past. In turn, the foreign investors get the benefit of access to a more highly developed system of private equity than is frequently available overseas.

### 2. Parties Harmed

While some parties inevitably will benefit from mandatory disclosure, others will be harmed. An examination of which parties fall in the latter category might well begin with the portfolio companies—the companies in which private equity funds invest. After all, it is the information about these companies that the private equity funds are vehemently trying to protect.[161]

158. Grimes, *supra* note 147, at C1.
159. Borrell, *supra* note 6, at 33.
160. Aragon, *supra* note 99, at 21. *See generally* Jerry Borrell, *Foreign Aid*, VENTURE CAP. J. June 2003, at 36, 36–37.
161. Not only are they trying to protect information about underlying asset values, but an IRR, which is simply the increase or decrease in the aggregate asset values of the portfolio.

At first glance, it is difficult to see what harm the release of a portfolio IRR will cause to a single company within the portfolio; fund names and corresponding IRRs by themselves are not very useful in determining the value of one asset in the portfolio. However, if the identities of the portfolio companies were also released, private equity firms argue, this could affect the firms' investment opportunities and competitive position simply by virtue of public knowledge that a private equity firm had invested.[162] In other words, revealing the identities of the portfolio companies could have an adverse effect on those companies' relationships with customers and suppliers because investment by a private equity company conveys important information about, among other things, the management structure of the business and future business plans. Therefore, it is important to the success of the investment that as little public information as possible be revealed about the portfolio companies. Yet, while some commentators express concern that top entrepreneurs will avoid private equity altogether because of the risk that private information will be revealed,[163] this risk is probably unfounded. Ultimately, few entrepreneurs have viable alternative sources of funds outside the private equity market.[164]

Public institutions also may be harmed by FOIA requests. As the University of Michigan and the University of California cases show, private equity firms prefer to deal with money not subject to FOIA, all else being equal. These and other public institutions now are being barred from some funds and kicked out of other funds to which they already have committed.[165] While public institutions are not being expelled from all funds,[166] it appears that the best and most exclusive funds—those with the highest returns—have been the swiftest in their reaction.[167] Therefore, without access to the highest potential returns, public investment opportunities are limited and public money has less value. This directly harms the beneficiaries of the public institutions—retirees and future retirees for public pensions, and students, faculty, and staff for public universities. Moreover, as at least one commentator

162. Grimes, *supra* note 147, at C1.

163. *See, e.g.*, Aragon, *supra* note 99, at 25.

164. As a rule, banks are not willing to extend financing to entrepreneurs based solely on an idea. Even when operations and product development have commenced, the business models of many entrepreneurs are so risky that banks will not extend loans to them. The available alternatives are family, friends, and high-net-worth "angel" investors, but often these do not provide enough financing.

165. Lawrence Aragon et al., *Will Colorado Set Trend With Disclosure Limits?*, VENTURE CAP. J., May 2004, at 5, 6; Gerry Langeler, *FOIA? GOIA! (Translation: Freedom of Information Act? Get Over It Already!)*, HIGH-TECH @DVISOR, http://www.millernash.com/HTA/showarticles.asp?Show=364.

166. Joel Rubinstein, *Viewpoint: How to Avoid the Open Records Spotlight*, VENTURE CAP. J., Sept. 2003, at 37, 38.

167. Aragon, *supra* note 99, at 21.

has speculated, this ultimately could result in higher taxes to cover the difference.[168] If this occurs, the public as a whole will suffer.

In addition, funds in which public institutions already have invested place these institutions between a rock and a hard place: Situations arise in which the institution must disclose under FOIA but may face a breach of contract claim under the conditions of the limited partnership agreement.[169] Regardless of whether or not the claim ever materializes,[170] this situation creates an additional source of conflict between the limited and general partners.

To protect themselves from disclosure obligations, many funds are cutting back disclosure to all investors.[171] Public institutional investors and other nonpublic investors in the same fund are thus harmed by less overall disclosure because they may be offered less information than they previously were given. Alternatively, some firms may disclose the same amount and type of information, but not in the form of a record that can be requested under a state FOIA (for example, an oral presentation at a shareholders' meeting). This type of disclosure is less useful than a written report because the audience receiving the information is smaller and the value of oral presentations is limited to how well such presentations are remembered. Finally, faced with the possibility that information given to public investors may be pried out by a FOIA request, some private equity firms have begun restricting disclosure solely to their private investors.[172]

Restricted disclosure, however, presents a potential difficulty to private equity firms. Under the Uniform Limited Partnership Act (ULPA),[173] which is awaiting adoption in several states,[174] "a limited partner may obtain from the limited partnership . . . true and full information regarding the state of the activities and financial condition of the limited partnership."[175] The partnership agreement may not alter this requirement.[176] Therefore, it appears

168. *Id.*

169. Fugazy, *supra* note 19, at 32.

170. The private equity firm general partner probably is unlikely to sue because of the bad publicity such a move would bring. *Id.* at 31.

171. Grimes, *supra* note 127, at A1.

172. *Id. But see* Primack, *supra* note 9, at 34 ("VCs apparently have decided that it would be a violation of fiduciary responsibility to send out a sparse report to one set of investors (public LPs) and a more detailed report to another group (private LPs).").

173. UNIF. LTD. P'SHIP ACT (2001).

174. *See* Harry J. Haynsworth, *The Unified Business Organizations Code: The Next Generation*, 29 DEL. J. CORP. L. 83, 94 n.77 (2004) ("[A]lmost all states currently have the prior version . . . [but] ULPA (2001) is expected to be widely adopted in the next several years.").

175. UNIF. LTD. P'SHIP ACT § 304(b) (2001).

176. "A partnership agreement may not . . . unreasonably restrict the right to information under Section[ ] 304 . . . ." *Id.* at § 110(b)(4). Professor Victor Fleischer raises the possibility that

that the current state of the law does not permit private equity funds to discriminate between public and nonpublic limited partners in the right to *obtain* information—though whether the fund affirmatively must provide such information is not clearly spelled out. Until the ULPA is fully adopted, however, it is unclear whether different classes of investors may be treated unequally.[177]

Finally, private equity firms may be harmed by mandatory disclosure, although such firms appear to split into two primary camps: those who oppose all disclosure, and those who would permit IRRs to be disclosed, but nothing else.[178] Those who oppose the release of IRRs have several reasons for their position. First, they argue that the public would not understand low returns on young funds.[179] Returns are mostly negative in the first several years of a fund's life and thereafter increase rapidly as portfolio companies mature.[180] Firms thus are concerned that the public might not understand the negative returns, and demand that the public institution sell its position or refrain from investing in the next fund.[181] Yet, it is difficult to evaluate the validity of this argument, as it is unclear whether the public could tolerate years of negative returns in exchange for a highly speculative future payoff.[182] Moreover, all portfolio valuations are speculative—nobody knows how much a company is worth until it is sold.[183]

While some firms are perhaps unconcerned that IRR disclosure is itself harmful, they fear that forced IRR disclosures are a slippery slope leading to greater disclosure down the road.[184] Indeed, the cases have shown that FOIA requests do not typically end with IRRs, especially when venture capital data resellers seek information for profit. There also have been requests for the disclosure of limited partnership agreements, which private equity firms resist

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a restriction to avoid a FOIA obligation might be reasonable under the Act, but the ULPA has not been widely adopted yet and courts have not addressed the issue.

177. *See* Copeland, *supra* note 72, at 6 (suggesting that different LPs may receive different levels of information about a fund's performance and investments).

178. Aragon, *supra* note 99, at 24.

179. *See* Primack, *supra* note 108, at 6; Dan Primack, *Q&A: Ted Dintersmith: 'Nobody Wins When We Invest Too Much Money,'* VENTURE CAP. J., Dec. 2002, at 25, 27. *But cf.* Aragon, *supra* note 99, at 24; Grimes, *supra* note 127, at A1; Primack, *supra* note 9, at 32.

180. This phenomenon is known as the "J-curve" because of the shape taken by the graphical depiction of returns over time. *See* Stephanie Oana, *Private Equity Goes Public*, LEGAL WK. GLOBAL, Feb. 11, 2003; The Regents of the University of California, *supra* note 12.

181. *See* Grimes, *supra* note 127, at A1; Primack, *supra* note 9, at 32 (describing IRRs of young funds as "barely more significant than pre-season football scores").

182. *See* Dale A. Oesterle, *A Clear-Headed Look at NGOs*, 13 COLO. J. INT'L ENVTL. L. & POL'Y 129, 131 (2002) (describing the short memories of the media and the public).

183. Primack, *supra* note 179, at 27.

184. Aragon, *supra* note 99, at 24–25; Heesen, *supra* note 17, at 44. *But see* Primack, *supra* note 9, at 33 (quoting the managing editor of the *San Jose Mercury News*, co-plaintiff in the UC case, stating that "[w]e're just looking for IRRs").

because they often will reveal the identities of limited partners other than the public institutions. These limited partners may want to keep everything secret, including the fact that they are invested in private equity.[185] Further, venture capital firms may feel that limited partnership agreements offer a backdoor means to elicit information that the federal government could not require under the federal securities laws.

It is difficult to tell, then, the extent to which private equity firms are harmed by disclosure. First, the industry reaction to state FOIA requests is far from uniform; different firms care about different things, and disclosure may harm some and help others. Second, there has been less aggregate investing recently due to economic factors beyond the control of state FOIAs. Such decreased investing activity makes it difficult to tell what the FOIAs' effect has been on the firms—there is no control group to compare against.[186] For example, fund sizes have been shrinking in general, in part due to the concern that some funds had been getting too large to be invested efficiently.[187] This gives private equity firms the option to pick and choose their limited partners; naturally, due to FOIAs, public institutions are not near the top of the list.[188] In fact, prior to the cases discussed above, some private equity firms already were rejecting public money because they perceived that "too many strings [were] attached."[189]

Ultimately, the increased interest in FOIAs has led to a decrease in the power of public pensions by making them less attractive investors.[190] There is a symbiotic relationship, however, between private equity firms and public institutional investors—22 percent of capital invested in private equity comes from public sources.[191] Thus, the balance of power between general and limited partners is currently unclear; public institutions need to invest their capital, and private equity funds need funding but are reluctant to accept it from such sources.

Do the benefits of forced disclosure to some parties outweigh the detriments to others? On some level, they may. Transparency in government arguably benefits society as a whole in a nonquantifiable way. Foreign investors, smaller venture capitalists, and data resellers are benefited; portfolio companies, public investors and their beneficiaries, and private equity firms believe they are harmed. While ulterior motives may lurk behind the recent political actions

185. Copeland, *supra* note 72, at 6.
186. Seven funds of $1 billion or more reduced their size. Aragon, *supra* note 99, at 21; Primack, *supra* note 9, at 34.
187. *See* Primack, *supra* note 179, at 27.
188. *Id.*
189. Aragon, *supra* note 99, at 21.
190. *Id.*
191. Grimes, *supra* note 127.

taken by some states,[192] state legislatures appear largely to have sided with those parties harmed by forced disclosure.[193] Therefore, several states now are amending their FOIA statutes to exempt some private equity data.

3. Reforming State FOIAs

As a result of disclosure cases such as those in California, Michigan, and Texas, many states are altering their laws. In March 2004, Colorado enacted a law exempting certain investment data from public disclosure.[194] Similar bills also have passed in Virginia and Michigan, and one is pending in Illinois.[195] This approach has not been followed in all states, though—similar bills were rejected in Massachusetts and Florida.[196] One common theme in the legislation has been that IRR data is not exempted from disclosure, but information beyond returns is exempted.

a. Colorado

Colorado amended the confidentiality provisions of its Public Employees' Retirement Association to allow private equity data to remain confidential.[197] The amended statute reads, "Information regarding real estate, private equity, private debt, timber, and mortgage investments by the association may be kept confidential until the transaction is completed if it is determined by the

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192. Besides the easy observation that private equity firms have a good deal of money (leading to possible political influence), the benefits and the detriments to public institutional investors should be aligned somewhat with those of the state legislatures—and their constituents—because the goal of these investors is to invest money for the benefit of the state coffers.

193. That consensus appears to be, generally, that IRR data should be released, while other information should remain confidential. *See supra* Part III.C.2.

194. Grimes, *supra* note 147, at C1.

195. Grimes, *supra* note 127, at A1; Grimes, *supra* note 147, at C1.

196. H.B. 4850, 183rd Gen. Ct., 2004 Reg. Sess. (Mass. 2004). Although the bill was enacted in substantial form, the governor line-item vetoed the private equity amendment portion of the bill on June 25, 2004. Had it been enacted as passed by the legislature, the amendment would have read:

> Any documentary material or data made or received by a member of the [Pension Reserves Investment Management] board which consists of trade secrets or commercial or financial information that relates to the investment of public trust or retirement funds, shall not be disclosed to the public if disclosure is likely to impair the government's ability to obtain such information in the future or is likely to cause substantial harm to the competitive position of the person or entity from whom the information was obtained. The provisions of the open meeting law shall not apply to the [Pension Reserves Investment Management] board when it is discussing the information described in this subdivision.

*Id.* § 82(6). MassPRIM has only lost one venture capital fund because it is a public entity, so perhaps Massachusetts does not feel that such an amendment is necessary. Dan Primack, *Battle Over Preventing Disclosure Data Shifts to the East Coast*, VENTURE CAP. J., July 2004, at 4, 6.

197. COLO. REV. STAT. § 24-51-213 (2004).

board that disclosure of such information would jeopardize the value of the investment."[198] While this statute does not permanently protect all data from discovery under a FOIA request, it can delay the request until the close of the fund. However, it remains to be seen if the level of generality in the Colorado statute will generate court challenges.

#### b. Michigan

Following the University of Michigan's departure from the Sequoia Capital fund, Michigan enacted the Confidential Research and Investment Information Act in April 2004.[199] As long as the information is "acknowledged by the investment fiduciary [private equity firm] as confidential," and the information on file with the public university "[pertains] to a portfolio company," the information is exempted from the disclosure provisions of Michigan's FOIA.[200] The Act in effect prohibits the University of Michigan from disclosing any private equity portfolio information except for fund names, aggregate amounts of investment, and aggregate rates of realized returns; but interestingly, this statute allows the public to view the names of portfolio companies in addition to the funds.[201] The inclusion of this provision therefore does not address one of the private equity firms' loudest objections—namely, that disclosing even the identity of a portfolio company can harm the company's future investment or business opportunities.

#### c. Virginia

Virginia's Attorney General has determined that confidential information provided by private equity funds is not subject to disclosure under that state's FOIA.[202] A Virginia bill enacted in the most recent legislative session codifies this view and is similar to Michigan law in that it allows the continued disclosure of fund names, the amount invested, and returns to date, but it prevents further disclosure of private equity information. Information provided "under a

198. 2004 Colo. Sess. Laws ch. 57 § 1.
199. MICH. COMP. LAWS ANN. § 390.1551–.1557 (West 2004 & Supp. 2005).
200. *Id.* § 390.1554a(1).
201. *Id.* § 390.1554a(1)(a).
202. *See, e.g.*, Pensions, Benefits, and Retirement: Virginia Retirement System, Administration of Government: Virginia Freedom of Information Act, Va. Op. Att'y Gen. No. 02-149 (Jan. 27, 2003) ("[C]onfidential information provided to the Virginia Retirement System by limited partnerships in the private equity market may be exempt from disclosure under The Virginia Freedom of Information Act.").

promise of confidentiality," and with a potentially "adverse effect on the value of [an] investment" will not be disclosed.[203]

While the existence of a promise of confidentiality is relatively easy to ascertain through the use of a confidentiality agreement, establishing an adverse effect may prove difficult in practice. The legislation does not describe who specifically is authorized to determine that disclosure would have an "adverse effect," though presumably great deference would be given to the boards responsible for public investments in the affected Virginia institutions, and to their respective private equity firms. The statute is also ambiguous in that it allows the "disclosure of information relating to the identity of any investment held."[204] It is unclear whether this allowance, like that of the analogous Michigan statute, permits the disclosure of underlying portfolio companies' identities or simply permits fund names to be disclosed.

#### d. Illinois

An Illinois bill amending the state FOIA passed both houses of the state legislature as of May 18, 2005.[205] This amendment adds to the list of exempted records, "financial information obtained by a public body, including a public pension fund, from a private equity fund . . . as a result of either investing or evaluating a potential investment of public funds in a private equity fund."[206] Unlike other states' new rules, this amendment explicitly permits public disclosure of "the identity of a privately held company within the investment portfolio of a private equity fund, unless . . . [such disclosure] may cause competitive harm."[207] Like the previous statutes discussed, the exemption "does not apply to the aggregate financial performance information of a private equity fund,"[208] thus continuing to allow for the disclosure of IRR data.

## IV. POTENTIAL SOLUTIONS

This final part addresses the problem of private equity funds excluding public investors or expelling them from funds to which the institutions have already committed. This occurs primarily because state legislatures have crafted FOIAs broadly such that public institutions are greatly affected, either

203. VA. CODE ANN. § 2.2-3711(21) (West 1995 & Supp. 2005).
204. *Id.*
205. S.B. 52, 94th Gen. Assem., Reg. Sess. (Ill. 2005).
206. 5 ILL. COMP. STAT. 140/7(1)(g) (West 1993 & Supp. 2005).
207. *Id.*
208. *Id.*

because legislatures have failed to consider the impact of FOIAs on private equity investments, or because the impact was deemed minimal.

The first potential solution is lobbying for change within individual states. This solution has several merits. First, it appears that states are recognizing the problems associated with FOIA disclosures of private equity information and generally are moving toward protecting such information.[209] Second, state-by-state lobbying gives states the ultimate control to amend their own laws without federal interference, thus allowing them to determine individually whether the benefits from open disclosure outweigh any potential loss of private equity returns for their public institutions. Perhaps unsurprisingly, this state-by-state approach appears to be the one advocated by private equity industry groups, which have lobbied for change on just such a basis.

The primary problem with the "lobbying" solution is uncertainty regarding what different states would do, if anything, and how private equity firms would react toward public institutions governed by dramatically different laws. For FOIA reform to be effective in a way that protects public institutions as well as private equity data, uniform adoption of a single standard is important, at least in states where public institutions hold private equity investments or plan to do so in the future. Without uniform adoption, private equity funds may be required by each state to disclose different information, and if forced to treat limited partners differently, private equity firms simply may choose to release the least possible information to all partners: The less the information released to the partners, the less the information the partners can be forced to release to the public. Or, in the area of voluntarily shrinking funds in which private equity firms can pick and choose their limited partners, public institutions might be avoided entirely. Thus, although a nonuniform solution is problematic from the states' perspective, it may not matter much to the firms.

Furthermore, efforts at implementing changes on a state-by-state basis, as private equity funds are doing now, have been stymied in several states.[210] And a state-by-state approach is unworkable, in any event, given the fluidity of information. Should only one state choose to permit public disclosure of private equity information, all states might well have permitted the same. Once the information is available to the public in one state, it is available everywhere.

A subset of the state-by-state approach that perhaps would be more effective is the development of a proposed uniform state law, such as the ULPA. The difference between a uniform state law and the more general state-by-state

209. *See supra* Part III.C.3. However, as outlined in the same section, some states have refused to amend their FOIAs to protect private equity information.
210. *See supra* note 196.

approach is that states may consider the drafting of a uniform state law—and its implementation by other states—as a nationwide endorsement of the law's potential benefits. Such an endorsement could make individual states more inclined to follow a proposed uniform law than to amend their state FOIAs under the influence of local lobbying alone.

A proposed uniform law would allow state autonomy in choosing whether or not to adopt, in whole or in part, but would be suggestive of uniform wording and structure. Uniform codes also may gain greater traction within the states than a state-by-state lobby because uniform laws are often drafted by a body with some legal influence, such as the American Law Institute or the National Conference of Commissioners on Uniform State Laws.[211] In any event, unanimous adoption of any proposed uniform state law is *not* vital for this approach to be successful. Although private equity firms undoubtedly would prefer a uniform standard affecting all limited partners, so as to minimize uncertainty in disclosure from FOIA requests, certainty also would exist as it rapidly became known which states have adopted the private-equity-protective laws and which have not. While a proposed uniform law might not sway states (such as Massachusetts and Florida) that already have rejected private-equity-protective FOIA changes, the strength of the proposed law would come from the certainty it provides to private equity firms and the pressure brought to bear on nonadopting states as other states across the nation begin to implement the new law and thereby endorse its underlying policy justifications.

Finally, enactment of a federal statute to supercede state FOIAs in the context of private equity information presents another potential solution. This solution offers complete uniformity across all states, and the certainty of knowing whether or not particular data is covered. Under a federal FOIA statute, there would be no conflicting rules about what to disclose to investors; thus, public institutions in different states would not face different laws and receive different information from their respective general partners. Moreover, since few, if any, private equity firms restrict entrance in their funds to investors solely within a single state, Congress presumably has the authority to enact such a federal statute under the Commerce Clause.[212]

211. *See* CONTRACT LAW: SELECTED SOURCE MATERIALS VIII (Steven J. Burton & Melvin A. Eisenberg eds., 2003) (describing how parts of the Uniform Commercial Code became law in forty-nine states). However, the acceptance of any one particular uniform state law tends to be fairly low. By 1996, 60.2 percent of the 103 uniform laws proposed by the National Conference of Commissioners on Uniform State Laws were accepted by fewer than twenty states, and 37.9 percent were accepted by fewer than ten states. Larry E. Ribstein & Bruce H. Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 J. LEGAL STUD. 131, 135 (1996).

212. U.S. CONST. art. I, § 8.

New federal legislation may also help avoid the so-called "race to the bottom."[213] In essence, some fear that to attract investors, some states will alter their FOIAs to protect *all* private equity data. By doing this, FOIA-conscious investors will be enticed to relocate to these states, and other states will have to alter their FOIAs to keep up.[214] Federal legislation eliminates this problem by imposing a standard law on all the states, but ultimately, there is reason to believe that a race to the bottom is not a pressing concern in the private equity context. FOIA directly impacts public institutional investors, which, as agents of the state, simply cannot move to another state to obtain more favorable treatment. Thus, if public institutional investors were in fact being injured by a state FOIA, the state could not rectify the situation without effecting a change in its own law. Additionally, public institutional investors are powerful, competent investors fully capable of protecting their own interests and able to influence state legislatures to reform laws to their benefit.

A federal statutory approach might take one of two forms: either a comprehensive statute laying out all the terms, or a broadly worded statute that delegates rulemaking authority to an agency, such as the SEC. The benefit of the former is that it creates a rigid system with built-in certainty; the benefit of the latter is a more adaptable system—statutes are notoriously difficult to amend or appeal, while agency rules are somewhat more susceptible to change. Private equity firms are generally small and flexible, and they avoid regulation based on exemptions from federal securities laws. Because of this, they are able to adapt quickly; thus, while one might imagine that such firms prefer generality and loopholes, they would benefit from the certainty of a rigid statute and likely would embrace it. A rigid statute, therefore, might be enacted more quickly and would be more beneficial from a certainty standpoint because it would be difficult to change.

213. *See generally* Frank B. Cross, *The Folly of Federalism*, 24 CARDOZO L. REV. 1, 12–18 (2002) (discussing the race to the bottom as a possible negative consequence of the American federalist system); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982); Nancy B. Rapoport, *Our House, Our Rules: The Need for a Uniform Code of Bankruptcy Ethics*, 6 AM. BANKR. INST. L. REV. 45, 89–92 (1998) (discussing the race to the bottom in the context of jurisdictional bankruptcy ethics law); Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race-to-the-Bottom" Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210 (1992).

214. Note that the race-to-the-bottom phenomenon does not apply to venture capital firms. These firms have investors nationwide and presumably have no incentive to relocate to be close to any one particular investor. Additionally, FOIA requests are directed at public investors and not at the firms or the funds themselves, so it does not matter where they are located.

Of the options available for addressing the problem of public disclosure, a uniform state law offers the best solution.[215] If accepted by all states in substantially the same form (an unlikely outcome, to be sure), such an approach would achieve the goal of uniformity on a national level. Private equity funds then could release the same data to all limited partners without fear that some would undergo forced disclosure. Additionally, if the law is worded in a way that protects underlying asset values, private equity funds could release the maximum amount of pertinent information to the limited partners without fear of disclosure. It also is important to note that uniform acceptance would be beneficial to public institutional investors—which, in turn, means that uniform acceptance benefits the states in which the public investors are located.

A second benefit of a uniform state law approach is that it allows states to choose whether or not to adopt the law based on the states' own FOIA preferences. While this may seem obvious, it is important; some states value disclosure more highly than private equity returns, while others prefer higher private equity returns to full disclosure.[216] States facing lower returns have the option to rectify this by protecting the data—after all, they cannot force private equity firms to accept public money. Will this lead to a race to the bottom? Some states already have resisted changing their disclosure laws, which suggests that a race to the bottom is unlikely to occur in the private equity context.[217]

The third benefit of a uniform state law is that it would give the drafters an opportunity to correct a secondary problem haunting private equity disclosures: the nonuniform reporting of IRRs.[218] Because of nonuniform reporting,

215. *See* Edward J. Janger, *The Locus of Lawmaking: Uniform State Law, Federal Law, and Bankruptcy Reform*, 74 AM. BANKR. L.J. 97, 101 (2000) (suggesting that a uniform state law approach is inappropriate when there are race-to-the-bottom concerns). As discussed previously, see *supra* note 214 and accompanying text, these concerns are inapplicable in the private equity context. Therefore, a uniform state law approach is appropriate.

216. *See supra* Part III.C.3 (discussing how Florida and Massachusetts have considered and rejected FOIA amendments protecting private equity data). This suggests that, although a uniform state law might be proposed, it is unlikely to be uniformly adopted. Yet, because uniform adoption benefits private equity firms and public investors alike, it still presents a worthwhile goal.

217. There is an economic efficiency argument to be made here. When the costs from maintaining a state FOIA favoring disclosure outweigh the benefits, economic theory suggests that states will adopt laws protecting private equity data. However, this is based on a slew of assumptions that are not necessarily true: that lawmakers take into account all the direct and indirect costs and benefits (that is, in addition to lower returns, the social costs of raising taxes and other state budgetary concerns, missing out on future investment opportunities, and so on); that lawmakers are qualified to balance these competing concerns and fully understand their implications; and that lawmakers are not overvaluing the release of private equity data when the ultimate result may be that there is no private equity data to be released.

218. *See generally* Justin Judd, Note, *A Valuation Standard for Venture Capital Fund Portfolio Companies?*, 9 STAN. J.L. BUS. & FIN. 105 (2003) (describing a lack of industry standards for

the same IRR number from two private equity funds might have been calculated according to entirely different metrics, and hence, represent completely different valuations of the growth of the underlying assets. While financial statements of public companies are somewhat standardized, based on the rules set out by the Financial Accounting Standards Board, there is no similar oversight board that mandates a "correct" way to calculate IRRs.[219] Indeed, some industry groups have suggested replacing the IRR as a tool to measure fund performance with a strictly cash-in/cash-out standard.[220] However, the appeal of IRRs lies in their ability to reduce fund performance to a single number. Because standardized IRRs would be much more useful for comparison, a proposed uniform state law could condition protection of underlying asset values and other private equity data on the calculation of IRRs according to a specific formula.[221]

How does the uniform state law process work? Essentially, an organization such as the National Conference of Commissioners on Uniform State Laws confers and drafts the law.[222] The organization approves the draft and then lobbies for its enactment in state legislatures.[223] This process has taken years in other areas of law—while drafts are refined and rewritten[224]—but the process might be expedited for private equity data because the law need not be long or comprehensive, and the need for its protections is pressing.

reporting information to VC investors). This problem could be solved by tying this suggestion into a federal statutory solution as well. Many thanks to Professor Fleischer for this creative solution to the problem of nonuniform IRR reporting.

219. The National Venture Capital Association website declares that "investors try to conservatively value their investments using guidelines or standard industry practices and by terms outlined in the prospectus of the fund," but it is unclear where these "standard industry practices" come from. National Venture Capital Association, The Venture Capital Industry—An Overview, http://www.nvca.org/def.html (last visited Aug. 19, 2004). The private equity data released by the University of California in response to the lawsuit discussed *supra* Part III.B.1 prefaces the data by stating that "each General Partner uses different valuation policies to determine the net asset value of the partnership, as no industry standard currently exists." The Regents of the University of California, *supra* note 12.

220. *See* AltAssets, *Trends: April 2002* (Apr. 30, 2002), http://www.altassets.com/roundup/arc/2002/nz842.php (last visited Nov. 16, 2004).

221. This contention assumes that the uniform law would permit the release of IRR data. This is based on: (1) most recent FOIA amendments allowing FOIA requests to continue to reach IRR data, (2) the varied private equity industry response to IRRs being released, with few firms opposed to the release of *any* information, and (3) the assessment that the public has a right to know what kind of return money invested in private equity is earning. However, release of IRR data is not vital to the adoption of a uniform law and might easily be excluded if the drafters intend that no information be released.

222. Ribstein & Kobayashi, *supra* note 211, at 144.

223. *Id.*

224. *See* Harry Kyriakodis, What Librarians Should Know About ALI and ALI-ABA, http://www.ali.org/ali/librarians.htm (last visited Oct. 26, 2004).

Any uniform state law should mimic the structure of the several amended state FOIAs already enacted. As noted above, the proposed law need not be especially comprehensive; nor should it be specific to any one subset of public institutions, for this would not be applicable to all states or state public institutions that invest in private equity funds. As most states already have exceptions in their FOIAs regarding information subject to disclosure, the optimal approach would add one further exception, perhaps structured like this:

> Private equity and venture capital information in the possession of a public body, including, but not exclusive to, public retirement systems and public universities, obtained for the purpose of or in the process of investing in such a fund, shall not be subject to the disclosure requirements under this state's Freedom of Information Act.
>
> This section shall apply only if the following information is made available to the public:
>
> (1) the names of any funds invested in;[225]
> (2) the vintage dates of the funds;
> (3) the amount of financial commitments to the funds by the public body;
> (4) the amount of cash paid and received from the funds, to date; and
> (5) the funds' internal rates of return (IRRs), calculated as annualized effective compound rates of return using monthly cash flows to and from investors and the residual value of the investment as the terminal value of the investment.[226]

This hypothetical law would preserve the privacy interest that is the main concern of private equity firms: namely, the underlying portfolio company

225. FOIA helps address the self-dealing concern. Like the UTIMCO case, *see supra* Part III.B.2 and accompanying text, in which political connections between investors and fund managers were feared (though not found), cronyism in the venture capital industry is an area of public concern. *See, e.g.*, *CalPERS and Cronyism*, WALL ST. J., Oct. 18, 2004, at A18 (detailing CalPERS's personal connections with its advisors and funds). Disclosing the names of funds invested in, by itself, will not bring self-dealing into the public light. However, getting the type of information necessary to discover these relationships is administratively impossible. While an Orwellian scenario in which each fund manager must list his friends, family, and acquaintances so that the public could scrutinize all his interpersonal relationships sounds farfetched, there is possibly no other complete solution to the cronyism problem. Therefore, releasing the names of the funds (including the names of the firms that raised the funds) divulges information to the public that will allow a reasonable level of evaluation while respecting the individual's right to privacy. Scrutiny may demonstrate cronyism if a public institution is investing in a disproportionate number of funds raised by a particular firm, for example.

226. Residual value is the estimated value of the assets of the fund, net of fees and carried interest. This method of calculating IRR is fairly widespread, though by no means standard. The wording of this section mirrors that on the website of the *European Venture Capital Journal*. *See* Press Release, European Venture Capital Journal, 2001 PE Performance Figures (Mar. 15, 2002), *at* http://www.evcj.com/evcj/ZZZ292XUMYC.html (last visited Sept. 15, 2005).

information. Disclosing the IRRs and fund names gives the public information about how its money is being invested, assists in the making of informed decisions, and helps in the fight against cronyism. Thus, the law also satisfies the goal of increasing the accountability of public investments.

Under the proposed law, the different constituent groups benefit as well: Data resellers get some information to sell; young private equity funds can capture public partners that may require even more disclosure; all private equity funds get some information about their competitors' successes and failures; beneficiaries of the investments gain the knowledge of the aggregate performance of their capital; and because disclosure is minimal, public institutions will not be regarded disfavorably by the firms.

## CONCLUSION

Financial markets do not appreciate uncertainty. Political uncertainty can often destabilize financial markets, even if the market is liquid. In the case of private equity, which is an illiquid market almost by definition and certainly by practice, it can be more difficult to ascertain the consequences of political uncertainty, as economic effects are seldom attributable solely to one factor. While it is difficult to ascertain how much state FOIAs have harmed the private equity industry, it is clear that the industry has retaliated against FOIA disclosure by restricting the ability of some public institutions to participate in the most lucrative investment funds.

Restricting the investment opportunities of public investors reduces their ability to benefit their constituencies—namely, the public. While the intent of FOIAs and public disclosure acts is generally to make government more transparent and accountable, something must be done when these statutes actually harm the public by reducing the value of investments with public money. Although many of the effects are presently nonquantifiable, it appears that the parties benefited most—private equity data resellers and smaller private equity firms—were not the intended beneficiaries of state FOIA laws.

It is imperative to find some kind of solution in the near future. As cases arise without the guiding clarity of pertinent public investor exemption statutes, the court system runs the risk of inconsistent decisions, or decisions contrary to or beyond the intent of the FOIA framers. It is up to the states to correct these state-law problems for themselves, and indeed, they have many incentives to do so. However, states should receive some guidance toward an optimum solution so they may take into account all costs and benefits impacting the affected parties—and not simply a special interest lobby for private equity or a fuzzy "public." Ultimately, a suggested uniform state law offers an appropriate means to debate, lay out the issues, and come to a solution that balances the desire for transparent government with the need for an optimal investment strategy for public funds. Of course, it is difficult to predict how many states would adopt such a uniform law. Yet since it appears that most states considering a FOIA amendment have made some kind of change, this approach could gain momentum, ultimately increasing certainty for private equity firms and increasing revenues for the public investors in their funds.

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