

COMMENT

Unlocking the Potential of Art Investment Vehicles

INTRODUCTION

Art as investment has become an increasingly prominent feature of the art world.¹ It is now common for investors to collect pieces based largely on their anticipated future resale value rather than their aesthetic value.² Surveys have found that half of art collectors consider investment returns to be an important motivation for their art purchases,³ and 88% of wealth managers think art and

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1. NOAH HOROWITZ, ART OF THE DEAL: CONTEMPORARY ART IN A GLOBAL FINANCIAL MARKET 153 (2011) (“The watershed study of historical art prices is Gerald Reitlinger’s *The Economics of Taste*, published in three volumes between 1961 and 1970 [He concluded that] ‘[b]y the middle of the 1950s, after two world wars, a world financial depression, and a world wave of currency inflation, “art as an investment” had lost any stigma that it might once have possessed.’”); Kyle Sommer, *The Art of Investing in Art*, J.P. MORGAN (2013), <http://www.jpmorgan.com/country/US/en/jpmorgan/is/thought/magazine/3Q2013/art> [<http://perma.cc/6H5R-JW9E>] (“Art has long been considered an investment of passion Only recently has art investing been viewed through the lens of modern portfolio theory”).
 2. See Sommer, *supra* note 1 (“In the 2011 RBC/Capgemini Global Wealth Management Financial Advisor Survey, 42 percent of advisors believe their [high net worth] clients invest in art primarily for its potential to gain in value.”).
 3. *Art & Finance Report 2017*, DELOITTE 142 (2017) [hereinafter DELOITTE 2017], <http://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/artandfinance/lu-art-finance-report.pdf> [<http://perma.cc/K3VS-M4JY>]. In addition, 36% of art collectors said that portfolio diversification is an important motivation for them when buying art, and 21% said that hedging inflation is an important motivation. *Id.* 86% of art professionals said that their clients buy art and collectibles for emotional reasons but also focus on investment value. *Id.* at 23.

collectibles should be included as part of a wealth management offering,⁴ up from 55% in 2014.⁵

Heightened interest in art investing, along with growing interest in investing in pleasure assets more generally,⁶ has led to a boom in the art market despite conflicting accounts regarding the attractiveness of returns on art investment.⁷ According to a recent study, the global art market has exploded over the last ten years, nearly doubling in size.⁸ This boom is driven not only by U.S. investors,

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4. *Id.* at 98. Fifty-four percent of wealth managers see art as a way to safeguard value. *Id.* at 23.
 5. *Art & Finance Report 2016*, DELOITTE 54 (2016) [hereinafter DELOITTE 2016], <http://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/artandfinance/lu-en-artandfinancereport-21042016.pdf> [<http://perma.cc/78U7-GXQD>] (finding that 72% of art collectors are buying art for collecting purposes, but with an investment view).
 6. “Pleasure assets” (e.g., art, wine, and classic cars) now represent about 10% of the net assets of wealthy individuals. *Id.* at 83.
 7. See, e.g., DELOITTE 2016, *supra* note 5, at 106 (“Based on the Mei Moses[] family of fine art indexes the most recent 20-year (1995-2015) Compound Annual Return (CAR) for art was 5.26 percent, below the S&P500 total return of 8.33 percent. Post-war & contemporary and traditional Chinese works of art delivered compound annual returns of 10.71 percent and 9.13 percent respectively—above the performance compared with U.S. equities in the last twenty years. . . . In addition to return, relative risk is another important measure of financial performance. . . . [T]he S&P500 Total Return Index has been more volatile than all of the art indices over the last 20 years.”); Sommer, *supra* note 1 (“Though calculation methodologies, sample data and time periods vary, most studies show that over long periods of time art prices have trended upwards, kept pace with inflation and, in several studies, have outperformed more traditional asset classes such as equities and bonds over certain time periods.”). *But see* Arthur Korteweg et al., *Research: Is Art a Good Investment?*, STAN. GRADUATE SCH. BUS. (Oct. 21, 2013), <http://www.gsb.stanford.edu/insights/research-art-good-investment> [<http://perma.cc/V38Q-5WWV>] (“The returns of fine art have been significantly overestimated, and the risk, underestimated. Our research, based on the most complete auction database, BASI (Blouin Art Sales Index), shows the true annual return of art as an asset class over 1972 to 2010 was closer to 6.5%, instead of the 10% that the index shows. Moreover, holding an art fund in your portfolio does not increase the chances that the portfolio will outperform.”).
 8. Eileen Kinsella, *What Does TEFAF 2016 Art Market Report Tell Us About the Global Art Trade?*, ARTNET NEWS (Mar. 9, 2016), <http://news.artnet.com/market/tefaf-2016-art-market-report-443615> [<http://perma.cc/9966-KNNA>] (“Using data from dealers, auction houses, art and antique collectors, art and financial databases (including artnet), and industry experts, [cultural economist Clare] McAndrew tracks the growth of the global art market from year to year, analyzes regional performance, art buyers and world wealth, and examines the economic impact of the art trade on the global economy.”); *see also* Sommer, *supra* note 1 (noting that the size of the global art market, according to TEFAF, is \$56 billion). Note, however, that TEFAF dramatically revised its art market size estimate downward in 2017 to \$45 billion after changing its methodology to include fewer galleries. Shellie Karabell, *Just How Big Is the Art Market? Leaders Do Some Serious Numbers-Crunching*, FORBES (Mar. 15, 2017, 2:00 AM), <http://www.forbes.com/sites/shelliekarabell/2017/03/15/just-how-big-is-the-art-market-leaders-do-some-serious-numbers-crunching> [<http://perma.cc/36GP-6S2F>].

but also investors from emerging markets like China.⁹ Given that the population of ultra-high-net-worth individuals, the main players in art investing, is expected to grow by 43% by 2026 (in large part due to increases in wealth in emerging economies), the global art market is likely to continue to expand.¹⁰

Why have these investors been drawn to the art market? Four features of art have made it an attractive investment option. First, although the aggregate long-term rates of return in the art market tend to trail those in the stock market,¹¹ investing in art can be a valuable component of a portfolio diversification strategy.¹² Some studies have found that art prices have a low correlation with other asset classes, and may thus outperform the stock market during economic downturns.¹³ Second, during periods of high inflation, when the purchasing power of

9. In fact, in 2011, China overtook the United States as the largest auction market in the world, with 30% of the total international trade. NOAH HOROWITZ, *ART OF THE DEAL: CONTEMPORARY ART IN A GLOBAL FINANCIAL MARKET* 217 (2014). While the United States is still the world's largest overall art market, with a 38% market share by value, China has taken second place with 24%, surpassing the U.K. and France in the last decade. CLARE MCANDREW, *ART MARKET REPORT 2014*, TEFAP 22 (2014).

10. DELOITTE 2017, *supra* note 3, at 41.

11. See DELOITTE 2016, *supra* note 5, at 106 (noting that the 20-year and 50-year returns on fine art were lower than the returns on the S&P500).

12. See Jianping Mei & Michael Moses, *Art as an Investment and the Underperformance of Masterpieces*, 92 AM. ECON. REV. 1656, 1666 (2002) ("Our art index also has less volatility and much lower correlation with other assets as found in previous studies. As a result, a diversified portfolio of artworks may play a somewhat more important role in portfolio diversification."); see also Jeremy Eckstein, *Art Funds as Asset Class*, in FINE ART AND HIGH FINANCE: EXPERT ADVICE ON THE ECONOMICS OF OWNERSHIP 136, 136 (Clare McAndrew ed., 2010) ("[A] portfolio that includes art along with its more conventional assets offers risk-adjusted rates of return that are superior to portfolios without art."). In fact, 36% of art collectors stated that portfolio diversification is an important aspect of buying art, and 48% of wealth managers believe that asset diversification is a strong argument for including art in traditional wealth management and private banking. DELOITTE 2017, *supra* note 3, at 142, 116-17. But see Andrew C. Worthington & Helen Higgs, *Art as Investment: Risk, Return and Portfolio Diversification in Major Painting Markets*, 44 ACCT. & FIN. 257, 269 (2004) ("It is clear that even though art markets have very low and even negative correlations with financial market assets, their risk-return characteristics are so inferior to equity and debt markets that they are never included in the efficient set. . . . However, it is the case that as the number of assets increases the risk of the portfolio collapses to the individual covariances, such that the creation of a portfolio with much finer detail than the broad asset classes used here should illustrate at least some diversification benefits.").

13. DELOITTE 2016, *supra* note 5, at 107 ("The negative or close-to-zero correlation factor between the annual percentage changes in the different art categories and stock indexes for the last 20 and 50 years indicates that art may play a positive role in portfolio diversification."); Sommer, *supra* note 1 ("[S]tudies show that art can offer long-term return potential that is uncorrelated with other asset classes. . . . Undeterred by a rough economic environment in recent years,

currency is falling, art acts as a store of value.¹⁴ Third, with the number of ultra-high-net-worth individuals increasing worldwide, art prices have the potential to grow tremendously, generating large returns for investors.¹⁵ Finally, certain subsets of the art market have seen very large returns in recent years, increasing public attention on the potential of art for investment. For example, Post-War art¹⁶ has seen a 308% increase in price indices over the past decade.¹⁷ Although the art market initially floundered in the wake of the financial crisis, these factors have all contributed to generate the recent growth in art as investment.

collectors globally are paying record sums for top works.”); Clare McAndrew & Rachel Campbell, *Art Risk*, in FINE ART AND HIGH FINANCE, *supra* note 12, at 87; *see also* HOROWITZ, *supra* note 1, at 157-59 (discussing the role of artwork in a diverse portfolio); Rachel Campbell & Joshua Pullan, *Diversification into Art Mutual Funds*, in DIVERSIFICATION AND PORTFOLIO MANAGEMENT OF MUTUAL FUNDS 1, 4-5 (Greg N. Gregoriou ed., 2007) (noting that art may be part of an “optimal portfolio allocation”). The degree of correlation, however, varies by art market. For example, a study of emerging art markets found that while the Russian art market has a positive correlation with most common financial assets, the Chinese art market has a negative correlation, making it more suitable for hedging. Roman Kraeussl & Robin Logher, *Emerging Art Markets*, 11 EMERGING MKTS. REV. 301, 303 (2010).

14. Sommer, *supra* note 1 (“The obvious monetary benefit is the opportunity to gain a return on investment, though investors also recognize art as a way to store value, to hedge inflation and to diversify their portfolio allocation.”). One of the first art funds, the British Rail Pension Fund (BRPF), diversified its investments with fine art in an effort to hedge against a period of rapid inflation and rising interest rates. Campbell & Pullan, *supra* note 13, at 5. Fifty-four percent of wealth managers see art as a means to safeguard value. DELOITTE 2017, *supra* note 3, at 117.
15. Sommer, *supra* note 1 (“Market paradigms have shifted dramatically over the last several decades, as newly created wealth in emerging markets such as China, Russia and the Middle East has increased the number of participants in the art trade, giving the market greater resiliency.”); *Art & Finance Report 2014*, DELOITTE 21 (2014) [hereinafter DELOITTE 2014], <http://www.slideshare.net/AlloWebb/deloitte-arttactic-artfinancereport2014> [<http://perma.cc/2WV2-4HE2>] (“[T]he growth in sales of art and collectibles has been fuelled by the globalisation of the art market and an exceptional increase in wealth, especially in new growth markets such as Asia, the Middle East and Latin America.”); *id.* at 26 (“According to the annual World Wealth Report, the population of High Net Worth Individuals (HNWIs) has increased from 7 million individuals in 2003 with total wealth of an estimated US\$27.2 trillion, to 13.7 million individuals in 2013 with total wealth of US\$52.6 trillion (an increase of 93.3% in total wealth). The Asia-Pacific region has seen particularly strong growth, from 1.57 million individuals in 2003 with total wealth of US\$5.7 trillion to 4.3 million individuals in 2013 with wealth of US\$14.2 trillion (up 149% in the last ten years).”).
16. “Post-War art” in this case refers to works by artists born between 1920 and 1945. *The Art Market in 2015*, ARTPRICE.COM *Nota Bene* (2016), http://imgpublic.artprice.com/pdf/rama2016_en.pdf [<http://perma.cc/S7YR-K5AJ>]. The relevant war is World War II. *See, e.g., Post-War American Art*, ARTSY, <http://www.artsy.net/gene/post-war-american-art> [<http://perma.cc/57DY-SYRA>]; *Post-War European Art*, ARTSY, <http://www.artsy.net/gene/post-war-european-art> [<http://perma.cc/4GHN-EC5X>].
17. *The Art Market in 2015*, *supra* note 16, at 12-13.

The benefits of investing in the high-end art market, however, are largely only available to very wealthy individuals. Although artistic patronage has shifted over time from private commissions to institutional funding,¹⁸ and technology-driven online art businesses have shown the potential to lower transaction costs and barriers to entry,¹⁹ art investing generally still requires connections to the art world and the employment of costly middlemen.²⁰ Moreover, the fundamental vehicle for art investment remains the same: a single investor must put up enough capital to purchase an entire piece of artwork. Because a well-diversified portfolio requires that investors buy many pieces to mitigate idiosyncratic risk, art investing is almost exclusively the province of the wealthy. Moreover, the illiquidity of art as an investment product makes it less attractive to less wealthy investors who are less able to lock up their capital into assets they might have difficulty liquidating in the near future.²¹ That limited investor pool means that less wealthy individuals who would otherwise want to take advantage of art's financial and aesthetic value are excluded from the market, preventing the art market from reaching its full cultural and economic potential. As it has been for much of history, art investment is still largely restricted to a select group of elite investors.

A potential exception to these general limitations is art investment vehicles. Art investment vehicles are entities that allow groups of investors to pool their resources and reap the financial rewards of art as investment without individually owning the underlying artworks. One type of an art investment vehicle is an art fund. Art funds emerged in the 1970s and allow investors to pool their money

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18. See Stewart Dearing, *Cultural Critic Takes on Modern-Day Art Patronage*, BROWN DAILY HERALD (Nov. 3, 2006), <http://www.browndailyherald.com/2006/11/03/cultural-critic-takes-on-modern-day-art-patronage> [<http://perma.cc/HSY5-8YT8>] (describing the shift from individual patronage to patronage from corporations and governments).
 19. DELOITTE 2014, *supra* note 15, at 15 (“[C]ollectors and art professionals both indicated increased confidence in the future of consumer-to-consumer and dealer-to-dealer sales platforms for the online art industry. . . . 77% of art collectors and 69% of art professionals believe that the online art auction market will become one of the winning business models.”).
 20. The premiums paid to professional art buyers have “increased steadily . . . since the early 1990s and can account for upwards of 10-20 percent per transaction” HOROWITZ, *supra* note 1, at 171.
 21. Income risk and the expectation of future borrowing constraints reduce people’s willingness to invest in risky assets, including illiquid assets. Luigi Guiso et al., *Income Risk, Borrowing Constraints, and Portfolio Choice*, 86 AM. ECON. REV. 158, 158 (1996). Also, lower incomes and lower net worth have been empirically found to correlate with lower shares of risky assets. *Id.* at 165-66. This is “consistent with the presence of fixed transaction and information costs in acquiring risky assets, and/or with a utility function that exhibits decreasing relative risk aversion.” *Id.*

to invest in a collection of art.²² Art funds buy a set of pieces, store them until a maturation date, sell them, and then distribute the profits to investors. During this time – generally between five and seven years²³ – the art fund might loan the pieces out to its investors or to institutions,²⁴ but otherwise the pieces are completely removed from the market.²⁵ The benefits of art funds are that they allow investors with little knowledge of or connections to the art market to invest in the art market without dealing with the selection, maintenance, and promotion of pieces.

Despite these advantages, however, art funds still suffer from illiquidity, inaccessibility, and weak returns. Most art funds are structured like private equity funds, with high fees and long-term lock-ups.²⁶ Modeling themselves after other private equity funds, art funds typically charge a management fee of 1-3% annually and a performance fee of 20% of the profits.²⁷ In addition, with required minimum investments as high as \$1 million, participation in art funds is still generally restricted to very wealthy individual investors.²⁸ Moreover, the art-

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22. While individuals have been acquiring art in art clubs or similar collectives for investment purposes for centuries, the BRPF was the first to formally adopt the rubric of what we would today call an art investment fund. In 1974, a portion of the BRPF's capital was invested in over 2,500 works of art during a six-year period. Sommer, *supra* note 1. See generally *What Are Art Funds*, ART FUND ASS'N LLC, http://www.artfundassociation.com/_what_are_art_funds/basic_af.html [<http://perma.cc/A5U4-5NV5>].
 23. *Characteristics of a Typical Art Fund Investment*, ART FUND ASS'N LLC, http://www.artfundassociation.com/_what_are_art_funds/characteristics.html [<http://perma.cc/8QCC-J5XJ>]. This is similar to the standard lock-in period for private equity funds of five to ten years. John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1246 (2014).
 24. HOROWITZ, *supra* note 1, at 150.
 25. According to Philip Hoffman, the CEO of The Fine Art Group (formerly The Fine Art Fund Group), one of the largest art funds, 90% of the fund's holdings are in storage. Daniel Grant, *Art Market's Boom in Off-the-Wall Storage*, WALL ST. J. (June 22, 2007, 12:01 AM), <http://www.wsj.com/articles/SB118245527806143800> [<http://perma.cc/HD8C-LZMZ>]. Similarly, investors in the British Fine Art Fund rarely see the Fund's works of art, which are stored at Geneva's free port. Imogen Foulkes, *Geneva's Art Storage Boom in Uncertain Times*, BBC (Jan. 2, 2013), <http://www.bbc.com/news/world-europe-20696126> [<http://perma.cc/88K4-E7CJ>].
 26. HOROWITZ, *supra* note 1, at 149, 185.
 27. ALESSIA ZORLONI, *THE ECONOMICS OF CONTEMPORARY ART: MARKETS, STRATEGIES, AND STARDOM 151* (2013) (ebook); *What Are Art Funds*, *supra* note 22.
 28. One of the most prominent funds, the Fine Art Group, has a minimum investment of \$500,000 to \$1 million for its six funds, with only 30 to 40 individuals and institutions investing in each fund. Jessica M. Curley, *Art Investment Funds: The Basics*, ITS ART L. (May 19, 2015), <http://itsartlaw.com/2015/05/19/art-investment-funds-intro> [<http://perma.cc/49EJ-V4LJ>]. The much smaller Collectors Fund had an entry price of \$100,000 and 100 investors. Daniel Grant, *Dollars on the Wall? Art Funds Boom Along with Auction Houses*, OBSERVER

fund market remains a very small portion of the overall art market; out of the estimated \$64 billion art market,²⁹ art funds only manage around \$834 million of assets.³⁰ The art-fund market has been shrinking every year since its high of \$2.1 billion in 2012.³¹ Thus, while art funds have increased access to the art market to those with few connections to or little knowledge of the art market, their impact has been very limited.

Aside from doing relatively little to expand access to the art market, art funds have had limited financial success. The British Rail Pension Fund (BRPF), which started investing in art in the 1970s, is usually cited as one of the first art funds and has been the only large institutional art fund to date. In 1974, faced with high rates of inflation and poorly performing stock markets in the U.K., the BRPF decided to diversify its holdings by investing 3% (around \$70 million) of its portfolio in fine art.³² After liquidating its art holdings in 2000,³³ the fund achieved an average annual rate of return of 4% (in real terms) on its art collection, though mainly as a result of highly profitable investments in impressionist artworks that were fortuitously sold at the peak of the prices in that market.³⁴ Moreover, the U.K. stock market ended up having a massive recovery, with the FTSE-Actuaries Index rising from 61.92 in 1974 to over 3,000 in 2000.³⁵ Although the BRPF's investment in art succeeded in its stated goal of producing a real return after inflation, in hindsight the fund would have performed much better had it not invested in art.³⁶ Thus, although the BRPF is often cited as one

(May 14, 2014, 2:58 PM), <http://observer.com/2014/05/dollars-on-the-wall-a-booming-art-market-attracts-investors> [<http://perma.cc/G49F-YSC6>]. According to the president of the Art Fund Association, “[r]ecent market estimates indicate that [art] funds manage between \$700 million and \$1 billion.” *Id.*

29. Kinsella, *supra* note 8.

30. DELOITTE 2017, *supra* note 3, at 182 (noting that this is a conservative estimate). The United States and European art investment fund markets are estimated to have a combined \$461 million under management, while the Chinese art investment fund market alone is estimated to have \$373 million. *Id.*

31. *Id.*

32. Jeremy R. Howard, *Art Market: The 20th Century*, ENCYCLOPEDIA BRITANNICA (Nov. 10, 2017), <http://www.britannica.com/topic/art-market/The-20th-century> [<http://perma.cc/4J6F-3QDA>].

33. HOROWITZ, *supra* note 1, at 155.

34. *Id.*

35. Jeremy Eckstein, *Investing in Art: Art as an Asset Class*, in *THE ART BUSINESS* 69, 77-78 (Iain Robertson & Derrick Chong eds., 2008).

36. In fact, the fund might have performed better if it had allocated the \$70 million (£40 million) into a Post Office Savings Account. Peter Cannon-Brookes, *Art Investment and the British Rail Pension Fund*, 15 *MUSEUM MGMT. & CURATORSHIP* 406, 407 (1996). Nonetheless, the fund's

of the first success stories in institutional art investment,³⁷ its success was very limited at best.

Most attempts to create large, diversified art funds, however, have not experienced even this modest level of success, instead dissolving due to internal scandals, failing to raise sufficient funds, or liquidating their holdings with losses.³⁸ One of the few extant firms to have weathered these challenges successfully is the Fine Art Group (previously known as the Fine Art Fund), which has raised over \$500 million.³⁹ But even the Fine Art Group's returns have been disappointing, with the firm recently reporting a return of around 5% on its latest fund.⁴⁰ Overall, the limited and weak track record of the art-fund market has undermined its attractiveness to investors.⁴¹

Besides art funds, another form of art investment vehicles is art exchanges. Art exchanges allow less affluent investors to buy *and* sell highly liquid shares in the resale value of collections of artworks owned by companies that transact on the exchange.⁴² The idea behind art exchanges is that they mimic public stock

investment in art arguably did serve to diversify the portfolio, as has been stressed by some scholars. Campbell & Pullan, *supra* note 13, at 6.

37. Kevin Radell, *The State of Art Funds*, ARTNET (Sept. 14, 2005), <http://www.artnet.com/magazineus/news/radell/radell9-14-05.asp> [<http://perma.cc/W34C-ARAY>] (“Most articles these days that fan the flames of the booming potential for art funds, and most private art fund prospectuses, cite the impressive 11.3% annually compounded rate of return generated by the BRPF from 1974 to 1999.”); Alasdair Whyte, *Art Fund Background: Three Key Examples of Art Funds*, PRIV. ART INVESTOR (Nov. 5, 2014), <http://www.privateartinvestor.com/art-finance/art-fund-background-three-key-examples-of-art-funds> [<http://perma.cc/2ZNL-S2ZY>] (describing the British Rail Pension Fund as “a successful experiment for formal art funds”).
38. High-profile examples of failed art funds include Fernwood Sector Allocation Fund, Fernwood Opportunity Fund, and the Savigny Art Fund. See HOROWITZ, *supra* note 1, at app. c, tbl. c1.
39. Anny Shaw, *The Problem with Art Funds*, ARTSY (Jan. 9, 2017, 5:21 PM), <http://www.artsy.net/article/artsy-editorial-problem-art-funds> [<http://perma.cc/L5FJ-YJ4R>].
40. *Id.*
41. Seventy-four percent of wealth managers surveyed by Deloitte said that the lack of a track record for art funds is a main hurdle for incorporating art funds into their offerings. In addition, 59% said that the small size of the art fund market was a significant hurdle. DELOITTE 2017, *supra* note 3, at 191, 193.
42. Jason-Louise Graham, *Art Exchange? How the International Art Market Lacks a Clear Regulatory Framework*, in ART, CULTURAL HERITAGE AND THE MARKET: ETHICAL AND LEGAL ISSUES 319, 327-29 (Valentina Vadi & Hildegard E.G.S. Schneider eds., 2014); Shane Ferro, *Can Art Exchanges Ever Make Financial Sense?*, BLOUIN ARTINFO (Jan. 24, 2012), <http://www.blouinartinfo.com/news/story/756021/can-art-exchanges-ever-make-financial-sense> [<http://perma.cc/UZ4A-LWCR>]; Mairi Mackay, *Modern Art Shares from \$13 in New Art Stock Exchange*, CNN (Jan. 10, 2011), <http://edition.cnn.com/2011/BUSINESS/01/10/art.stock>

exchanges with low barriers to entry by allowing investors to easily sell their shares to other market participants.⁴³ Just as stock exchanges allow investors to buy and sell shares in companies, art exchanges allow investors to buy and sell shares in “art management companies,” which specialize in buying, managing, and selling artworks. Unlike art funds, art exchanges do not require minimum capital contributions and therefore are generally not limited to high-net-worth investors.⁴⁴ Moreover, by providing investors with a robust secondary market for their shares, investors are not locked in for several years as they are in art funds.

In terms of legal structures, the fundamental difference between the art fund model and the art exchange model is that art funds have external management structures whereas the art management companies selling shares on art exchanges have internal management structures. Art funds are managed by external managers who work for a firm that manages multiple funds.⁴⁵ This creates benefits of economies of scope and scale from managers being able to manage multiple funds and the resources of the firm being spread across these funds.⁴⁶ In contrast, art management companies, like other types of companies, have their own management teams.⁴⁷ Given the important role experts and middlemen play in the art market, the economies of scope and scale gained from sharing human capital across funds can be very beneficial in the art market. Nonetheless, the increased accessibility and liquidity offered by art exchanges could make them more attractive to less affluent investors who are excluded from the art fund market.

Art exchanges have been attempted over the past few years in the United States, Europe, and Asia with varying degrees of success. Only one art exchange was attempted in the United States, and it is unclear whether it ever actually

.exchange.paris/index.html [http://perma.cc/6WTC-6QC2]; Luca Poli, *Art Stock Exchange*, MYTEMPLART (Oct. 26, 2016), <http://news.mytemplart.com/art-stock-exchange> [http://perma.cc/N659-QCQ9].

43. See *supra* note 42.

44. Shares on art exchanges can be very inexpensive. See, e.g., Mackay, *supra* note 42.

45. This is the general idea behind what John Morley calls the “separation of funds and managers.” Morley, *supra* note 23, at 1232.

46. *Id.* at 1233, 1259.

47. Funds, in contrast, have “no employees or other operational assets and may even be prohibited from having them.” *Id.* at 1239. The management firm has all of the human capital and operational assets. *Id.*

launched and made any investment offerings.⁴⁸ Of the two art exchanges attempted in Europe, one struggled to gain regulatory approval, while the other suffered from insufficient investor interest.⁴⁹ In contrast, art exchanges in China have seen a very different problem: excessive speculation.⁵⁰ Two paintings on the Tianjin Art Exchange in China skyrocketed to seventeen times their original prices in less than three months.⁵¹ After the spike in value, shareholders panicked

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48. The Liquid Rarity Exchange generated substantial news coverage in 2012 with its plans to launch *public* art investment vehicles registered with the SEC within the next twelve to eighteen months. See, e.g., Dan Caplinger, *Want To Own a Picasso? Here's Your Chance*, AOL (Aug. 22, 2012, 1:30 PM), <http://www.aol.com/2012/08/22/want-to-own-a-picasso-heres-your-chance> [<http://perma.cc/W7LR-QSA9>]; Amir Kurtovic, *Saigh Developing Fund Backed by Rare Art, Collectibles, Fine Wines*, ST. LOUIS BUS. J. (Sept. 28, 2012, 6:00 AM), <http://www.bizjournals.com/stlouis/print-edition/2012/09/28/saigh-developing-fund-backed-by-rare.html> [<http://perma.cc/U8ZF-THMK>]. At the time, the company was considering “several fund proposals in the \$35M to \$100M range that could trade publicly . . . in the next 12 to 18 months.” Nicholas Forrest, *Can Shares in Art Be Successfully Traded by Liquid Rarity Exchange*, ART MKT. BLOG (Aug. 30, 2012), <http://liquidrarityexchange.com/26-publishers/88-can-shares-in-art-be-successfully-traded-by-liquid-rarity-exchange--artmarketblogcom.html> [<http://perma.cc/4YQQ-6KKW>]. The company would provide a technological platform that would enable investors to easily buy and sell shares. See Kurtovic, *supra*. Since 2015, however, there has been no news about the development of these funds. Curley, *supra* note 28 (indicating that Liquid Rarity Exchange intended to bring a product to market in the next few years). Also, the company’s website does not provide opportunities to buy shares in any funds. See *Fine Arts*, LIQUID RARITY EXCHANGE, <http://liquidrarityexchange.com/fine-arts.html> [<http://perma.cc/8RBJ-FLD8>]. The only other U.S.-based art exchange I was able to find was Tradeable Rarities Exchange (T-REX), which was started in 2015 by the CEO of Liquid Rarity Exchange (Mike Saigh) and the founder of Art Exchange (Pierre Naquin), a French art exchange that closed down in 2012. See *The T-REX Team*, T-REX TRADING, <http://www.t-rextrading.com/team> [<http://perma.cc/5WJ9-E2UJ>]. The company’s website does not appear to currently allow investors to invest, however, and clicking on “Get more information About Investing” leads to the general information page. See *Engage: Invest or Affiliate*, T-REX TRADING, <http://www.t-rextrading.com/engage> [<http://perma.cc/9CEP-X9CC>].
49. SplitArt, an art investment vehicle in Luxembourg, liquidated in 2012 after failing to obtain approval from Luxembourg financial authorities. Georgina Adam, *The Art Market: Bid To Save the Planet*, FIN. TIMES (May 17, 2013), <http://www.ft.com/intl/cms/s/2/ea0b4a42-bbc9-11e2-82df-00144feab7de.html> [<http://perma.cc/Z9XL-R3A7>]. Art Exchange, a Paris-based exchange, started selling shares but was still not “under the umbrella of any regulatory authority. Ferro, *supra*, note 42. Ultimately, Art Exchange delisted the two paintings it had put on offer after “less than 20% of the paintings’ shares had been purchased by investors who were growing impatient because trading could only begin once every share had been sold.” *Markets Created To Trade Shares in Artworks Hit Obstacles*, ECONOMIST (June 24, 2013), <http://www.economist.com/blogs/schumpeter/2013/06/investing-art> [<http://perma.cc/52YB-V7QE>].
50. See Li Jing, *Art: Experts Put Little Stock in Exchange*, CHINA DAILY (Apr. 8, 2011), http://usa.chinadaily.com.cn/epaper/2011-04/08/content_12291774.htm [<http://perma.cc/VEK7-VFYJ>].
51. *Markets Created To Trade Shares in Artworks Hit Obstacles*, *supra* note 49.

and started dumping their shares, so the exchange halted trading to avoid a market collapse.⁵² In the wake of this and other instances of rampant speculation on a variety of alternative asset exchanges, the Chinese government issued new regulations in 2011 that targeted these exchanges.⁵³ While some art exchanges in China closed in the wake of these new regulations, others continued to operate and new ones have since emerged.⁵⁴ Unlike art exchanges in the West, Chinese art exchanges are often created through government partnerships, so while they still face significant regulatory scrutiny, they also have some government support.⁵⁵ As discussed above though, outside of China, art exchanges have struggled to gain regulatory approval and spur sufficient investor interest. Thus, while art exchanges have the potential to create accessible and liquid art investment opportunities, they have mostly failed to get off the ground.

Art funds and art exchanges—collectively, art investment vehicles—have thus far faced numerous challenges, all of which have hampered their financial success. These challenges have also prevented art investment vehicles from achieving their potential to make art investment more accessible and liquid. Far from making it possible for the average person to own a fraction of a Picasso,⁵⁶ art funds have largely catered to wealthy individuals and, by adopting a private

52. Graham, *supra* note 42, at 328-29.

53. YONG ZHEN, CHINA'S CAPITAL MARKETS 97-98 (2013).

54. HARDY YONG XIANG & PATRICIA ANN WALKER, CHINA CULTURAL AND CREATIVE INDUSTRIES REPORTS 135 (2013) (describing how the "State Council Decision on Rectifying All Categories of Trading Exchanges and Effectively Preventing Financial Risk cleaned up around half of [the] cultural equity exchanges"); see Deng Zhangyu, *Art Exchange*, CHINA DAILY (Apr. 28, 2015), http://www.chinadaily.com.cn/culture/art/2015-04/28/content_20559757.htm [<http://perma.cc/NA5C-Y87Y>] (describing an art exchange that opened in China in 2015).

55. See, e.g., Li Jing, *supra* note 50 (explaining that "[t]hrough the [Tianjin Cultural Artwork Exchange (TCAE)] is privately owned, TCAE said it has won special support from Tianjin municipal government and was listed as one of the city's top 20 projects for financial innovation in 2009," and noting that the Shenzhen Cultural Assets and Equity Exchange was government sponsored); Marion Maneker, *China Opens Its Own Exchange for Art Sales*, ART MKT. MONITOR (Jan. 26, 2011), <http://www.artmarketmonitor.com/2011/01/26/china-opens-its-own-exchange-for-art-shares> [<http://perma.cc/YYP5-QXBC>] (describing the opening of the "government-backed" Tianjin Cultural Artwork Exchange); Poli, *supra* note 42 (describing how the Chinese State Council and People's Bank of China have begun a process of regulating art exchanges and explaining that some exchanges are owned by local authorities); Zhangyu, *supra* note 54 (describing a recent art exchange that was set up in part through a partnership with the Beijing municipal government).

56. Much of the excitement around art investment vehicles has been the idea that they would open art investment to most if not all investors. See, e.g., Poli, *supra* note 42; Kathryn Tully, *Art Investment for Everyone?*, FORBES (Aug. 29, 2012), <http://www.forbes.com/sites/kathryntully/2012/08/29/art-investment-for-everyone> [<http://perma.cc/YL2E-M3SB>].

equity model, have done little to increase liquidity and accessibility in the market. Art exchanges, on the other hand, other than a few in China, have failed to get off the ground.

This Comment argues that existing art investment vehicles have barely scratched the surface of their potential. Although there are many different issues facing art investment vehicles, this Comment focuses on their potential returns, liquidity, and accessibility as three of the most prominent areas where art investment vehicles have untapped potential that could be unlocked through structural changes.

Part I describes the features of the art market that make it difficult for art investment vehicles to increase the liquidity, accessibility, and potential returns of their offerings. Specifically, the inherent illiquidity of art as an asset, the challenges art investment vehicles face in navigating the primary market, and the regulatory hurdles faced in opening art investment vehicles to a wider population of investors are obstacles to the success of art investment vehicles. Part II proposes three innovations to current art investment vehicles that address these barriers. First, it analyzes how the development of a robust art rental market for works owned by art investment vehicles could decouple the aesthetic and resale values of these artworks. This change would more efficiently allocate the value of the art, increasing the liquidity and potential returns of art investment vehicles and allowing more people to possess artworks. Second, it proposes methods to better align the interests of primary market players (artists and galleries) and art investment vehicles. Works on the primary market have not been sold previously and thus are sold directly by an artist or gallery, whereas works on the secondary market are generally sold by one collector to another, often with the assistance of an auction house or art dealer. Aligning the incentives between primary market players and art investment vehicles would give the latter access to top works on the primary art market, where pieces generally sell for less and have a greater potential to significantly appreciate in shorter periods of time. This would not only provide potential financial benefits to investors in the form of higher returns and more liquid assets, but would also provide rare access to what is currently the least accessible segment of the art market—the high-end primary market. Finally, by leveraging new securities registration exemptions, Section II.C discusses how art exchanges could open up art investing to a broader array of investors while also increasing liquidity in art ownership through the creation of a secondary market for art securities. Through these three proposals—the creation of a robust rental market for fine art, gaining access to the primary market, and the creation of art exchanges that leverage recent regulatory changes—the potential benefits of art investment vehicles could be leveraged to open up the art investment market to a broader array of investors and provide investors with art investment products with higher potential returns and liquidity.

I. LIMITATIONS OF ART INVESTMENT VEHICLES

Art investment vehicles have thus far had limited financial success and failed to significantly expand the art investment market. This Part describes some of the structural features of the art market that have hampered the success of art investment vehicles by limiting their potential returns, liquidity, and accessibility.

The first and most fundamental challenge in the art investment market is the lack of sufficient liquidity.⁵⁷ Liquidity refers to the extent to which an asset or security can be quickly bought or sold without affecting the asset's price.⁵⁸ For illiquid assets, there is a significant tradeoff between how quickly the piece can be sold and at what price it can be sold – illiquid assets generally require an investor to hold the asset for a significant amount of time before they are able to sell the asset for a profit.⁵⁹ Given that art can take many years to appreciate sufficiently to offset transaction, storage, and maintenance costs,⁶⁰ art is a particularly illiquid asset. This lack of liquidity makes art a less attractive investment option, especially for investors with lower capital reserves, who are less able to freeze up a large amount of capital in an asset they cannot sell in the near future.⁶¹ The illiquidity of art as an asset makes it difficult for art investment vehicles to offer more liquid products to investors, since providing investors with liquidity would require selling artworks prematurely, which would likely lead to losses. Thus, art

57. See, e.g., MELANIE GERLIS, ART AS AN INVESTMENT?: A SURVEY OF COMPARATIVE ASSETS 16 (2014) (“One of the most glaring risks of owning art is the lack of liquidity in its market.”).

58. *Liquidity*, INVESTOPEDIA, <http://www.investopedia.com/terms/l/liquidity.asp> [<http://perma.cc/6U59-C3ZZ>].

59. GERLIS, *supra* note 57, at 16 (“Illiquid assets either take a long time to sell or the very act of selling them in a hurry sends their price into a tailspin.”).

60. Researchers have found that after accounting for transaction costs the average return on artworks is positive after close to four years, with returns increasing with longer holding periods. Roman Kräussl & Ali NasserEddine, *Art as Investment: A New Perspective* 19 (May 2017), http://economics.soc.uoc.gr/macro/docs/Year/2017/papers/Art_as_an_Investment_May_2017.pdf [<http://perma.cc/VVG3-UH6G>]; see also Daniel Grant, *Picture This Investment: Four Investing Pros Discuss the Risks and Rewards of Buying Art*, WALL ST. J. (Dec. 15, 2013), <http://www.wsj.com/articles/what-sort-of-return-are-you-getting-above-your-fireplace-1387056633> [<http://perma.cc/LK37-GQU3>] (describing a rule of thumb of an 8% annualized net return on art investment over a minimum holding period of five years). The optimal holding period, however, depends on the category of art. Post-War and Contemporary Art can appreciate much faster than works in the categories of Old Masters, Impressionists, or Modern. Roman Kraeussl, *To Have and To Hold?*, BLOUIN ARTINFO (2013), http://www.art-finance.com/AA_2013_Summer.pdf [<http://perma.cc/KA2W-HD8W>].

61. See *supra* note 21.

investment vehicles often face a tradeoff between providing investors with greater liquidity versus greater returns.

Second, art investment vehicles generally purchase pieces on the secondary art market, rather than on the primary market. Although most works on the primary market have little resale value,⁶² works sold by high-end galleries often have a greater potential to appreciate significantly on shorter time horizons than works on the secondary market.⁶³ Moreover, given that the secondary market constitutes only half of the art market, purchasing on the secondary market not only prevents art investment vehicles from accessing the potentially more lucrative primary market,⁶⁴ but also constrains art investment vehicles to giving investors access to only half of the art market.⁶⁵ The main reason for the limitation of art investment vehicles to the secondary market is that the primary market has high barriers to entry: primary market players are very wary of speculators. In an attempt to control the price of the artist's work over time, primary market players want to sell their best works to collectors who will keep the artworks off the market for the foreseeable future.⁶⁶ Yet, this goal is often in tension with the incentive of art investment vehicles to sell artworks at their peak prices. Because of these conflicting incentives, primary market players have little motivation to

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62. OLAV VELTHUIS, TALKING PRICES: SYMBOLIC MEANING OF PRICES ON THE MARKET FOR CONTEMPORARY ART 99 (2005) (“[M]ost artists do not have a secondary or resale market After being sold on the primary market, their work will never appear on the market again.”). Given that most artwork sold on the primary market does not have a significant resale market, this Comment focuses on the ability of art investment vehicles to access quality works from top galleries.
63. Manuel Gerber, *Primary Art Market Investments—A Safe Haven When All Else Suddenly Correlates?*, ART FUND TRACKER 1, 7-8 (Nov. 2008), <http://www.cherryartfoundation.com/pdf/Art%20Fund%20Tracker.pdf> [<http://perma.cc/F8W6-7TX4>] (describing how “good galleries” are selective of their buyers, often at the expense of near-term cashflows, and also showing how the rates of return for young artists represented by high-quality primary market galleries are much higher in the short-term than returns in the contemporary art market as a whole).
64. See HOROWITZ, *supra* note 1, at 178 (“[A]rt funds may have only limited access to the [primary] market sector where investment rewards, and risks, are arguably the greatest.”).
65. See ZORLONI, *supra* note 27, at 58 (describing how the primary market constitutes around half of the global art market).
66. Canice Prendergast, *The Market for Contemporary Art* 15-16 (2014), <http://faculty.chicago-booth.edu/canice.prendergast/research/MarketContemporaryArt.pdf> [<http://perma.cc/S792-8W3N>]; Chiara Zampetti Egidì, *5 Unspoken Rules of the Art Market New Collectors Need to Know*, ARTSY (Aug. 6, 2015 11:05 AM), <http://www.artsy.net/article/artsy-editorial-5-unspoken-rules-of-the-art-market-new-collectors-need-to-know> [<http://perma.cc/Z94K-AEED>].

sell top works to art investment vehicles.⁶⁷ In fact, gallerists arguably are more incentivized to try to pass off less marketable pieces to art investment vehicles,⁶⁸ preventing art investment vehicles from accessing the potential benefits of investing in the primary market. Consequently, art investment vehicles often must buy pieces on the secondary art market and forgo accessing top primary market works.⁶⁹ Exclusion from the primary market is thus another factor inhibiting the success of art investment vehicles.

Third, there are regulatory barriers to the creation of successful art exchanges in the United States. The key feature of art exchanges is the ability to sell highly liquid shares to a broad investor base, but securities regulations in the United States have historically only provided two options for art investment vehicles: private funds that issue restricted shares (shares with limited resale rights) to accredited investors⁷⁰ or public securities like shares in mutual funds or public companies. Given the high costs and disclosure requirements of going public, art investment vehicles in the United States have almost exclusively taken the form of private art funds.

67. See HOROWITZ, *supra* note 1, at 178 (“[E]ven if dealers and gallerists are willing to trade with art funds in the secondary market, they may hesitate to do so in the primary market where they have the most incentives to protect their artists’ career paths.”).

68. Most art funds in the past have relied primarily on contracts with outside experts to help them with the selection, management, and selling of works. This can create conflicts of interest, however, as outside contractors are rarely sufficiently incentivized to provide the best opportunities to the art fund. Given that many of them are gallerists and dealers themselves, they often have incentives to pass off less marketable pieces to art funds. Although these outside contractors usually are given some commission based on the sale price of the work, these incentives only partially mitigate the issue. “The main problem of [art] funds is the risk of conflict of interest, as in the board are often sitting dealers, auction house operators, gallery owners and advisors which, in most cases, determine the market.” ZORLONI, *supra* note 27, at 152. In fact, Sotheby’s reportedly passed along low-investment-grade assets to the BRPF when it was acting as the fund’s art advisor. HOROWITZ, *supra* note 1, at 179.

69. Brian L. Frye, *New Art for the People: Art Funds & Financial Technology*, 93 CHI.-KENT L. REV. 113, 129-30 (2017) (describing how the “outsider” status of art funds makes them unable to purchase works on the primary market and that instead, “art funds typically purchase works on the secondary market in public auctions”).

70. For individual investors, being an accredited investor requires the person to either (i) have a net worth (or joint net worth with his/her spouse) of over \$1 million or (ii) have an annual income over \$200,000 for the past two years or joint annual income with his/her spouse of \$300,000 over the past two years along with a reasonable expectation of reaching the same income level in the current year. 17 C.F.R. § 230.501(a)(5)-(6) (2017).

A. Lack of Liquidity

An overriding problem of art investment vehicles is that they operate in a particularly illiquid market. Investors value liquidity because it reflects how easily they can turn their investments into cash.⁷¹ Illiquid assets limit investors' access to their capital and are consequently riskier—the investor is betting that he or she will not need to access the capital before the asset can profitably be liquidated. In fact, studies have shown that illiquid assets must have higher returns or lower prices compared to liquid assets to adequately compensate investors for their inability to quickly turn their investments into cash.⁷²

Compared to other assets, achieving liquidity in the art market presents a set of unique challenges. Art is, for the most part, not fungible: each piece is unique. This, coupled with the high prices of artworks, makes the resale market for any individual artwork comparatively thin.⁷³ The potential cohort of buyers is limited to wealthy individuals with affinity for that particular work.⁷⁴ In fact, the challenges created by this thin market explain in part the prominent role auctions and art fairs play in the art market to bring art market players from around the world together at specific times and places in order to create a viable marketplace with enough buyers and sellers. Outside of such events, it can be difficult to find a competitive market for buying or selling artworks.⁷⁵ Moreover, auctions

71. See, e.g., GERLIS, *supra* note 57, at 16 (“[L]iquidity is broadly defined as the ability to sell an investment for cash (i.e. to liquidate it).”).

72. See, e.g., *id.* (“In financial terms, the ‘liquidity discount’ means that investments that are less liquid generally trade for less than those that are more liquid.”); Yakov Amihud et al., *Liquidity and Asset Prices*, 1 FOUND. & TRENDS IN FIN. 269, 271-72 (2005).

73. Thin markets are markets with a low number of buyers and sellers, leading to greater price volatility and less liquidity. *Thin Market*, INVESTOPEDIA, <http://www.investopedia.com/terms/t/thinmarket.asp> [<http://perma.cc/3MHP-TSN6>]. If markets are thin, sellers can suffer from “search friction.” Search friction refers to the difficulty of locating a counterparty who is willing to make a trade. In such situations, the seller “faces a tradeoff between search and quick trading at a discount.” Amihud et al., *supra* note 72, at 271; see also David Walker, *Rethinking Rights of First Refusal* 18 (Harvard Law Sch. John M. Olin Ctr. for Law, Econ. & Bus. Discussion Paper Series, Paper No. 261, 1990), http://lsr.nellco.org/harvard_olin/261 [<http://perma.cc/4FH7-5FYK>] (“The buyer’s search costs are related to the pricing transparency and fungibility of the property.”).

74. Prendergast, *supra* note 66, at 2.

75. Outside of such events, art dealers are often responsible for finding and matching buyers and sellers, but some only sell to a small group of wealthy clients they have long-term relationships with. Olav Velthuis, *Art Dealers*, in A HANDBOOK OF CULTURAL ECONOMICS 28, 38-39 (Ruth Towse ed., 2d ed. 2011).

typically take three to six months between consignment and sale,⁷⁶ so it can be quite difficult to sell artworks quickly even if a market exists.

Art also poses special valuation problems, further hampering liquidity. Since demand for a particular piece is largely dependent on the aesthetic or intellectual appreciation that a small cohort of wealthy collectors has for it,⁷⁷ it can be difficult to accurately value any particular piece, and the ability to find a buyer willing to pay a particular valuation can vary substantially over time depending on idiosyncratic and subjective factors. Since liquidity involves the ability to quickly find a buyer at a given price, these valuation challenges can also undermine liquidity. Moreover, the factors that cause an artwork's value to appreciate often operate on a long time horizon. Artworks gain value when artists become more established and develop a more prominent reputation.⁷⁸ However, recognition of artistic movements and the canonization of artists can take a significant amount of time.

Finally, investing in art entails significant maintenance and transaction costs.⁷⁹ Buying and selling artworks can be expensive. Auction houses generally charge buyers 10-25% of the sales price, and sellers up to 10% of the sales price.⁸⁰

76. HOROWITZ, *supra* note 1, at 170.

77. See Sharon V. Thach & Kimball P. Marshall, *An Illustration of Opaque Markets: High End Fine Art 5-6* (2016), <http://ssrn.com/abstract=2733153> [<http://perma.cc/9E9V-9EUR>] (describing how the valuation of art is “inherently subjective and intangible” with “no practical usage,” such that the value “depends on the opinions and tastes of others with respect to the artist generally and the artwork,” in particular “art historians, art valuation specialists, museum curators, and professional critics in influential publications”); see also Sommer, *supra* note 1 (“Art is unique as an investment in that there are many non-monetary investment reasons behind collecting. Surveys have shown on average only 10 percent of HNWI’s own fine art and paintings purely as a financial investment, though other surveys suggest a much higher percentage.”).

78. Jens Beckett & Jörg Rössel, *The Price of Art: Uncertainty and Reputation in the Art Field*, 15 J. EUR. SOC’YS 178 (2013) (“[T]he artistic status of an art work or artist – the ‘quality’ – evolves from an intersubjective process of experts, institutions, and media in the art field assessing work and conferring reputation [R]eputation is perceived as a quality signal by buyers and is therefore the basis for determining the economic value of art works.”); Susanne Schönfeld & Andreas Reinstaller, *The Effects of Gallery and Artist Reputation on Prices in the Primary Market for Art: A Note 1* (WU Vienna Univ. of Econ. & Bus., Dep’t of Econ. Working Paper No. 90, May 2005), <http://epub.wu.ac.at/342> [<http://perma.cc/DUL3-P9JQ>].

79. See, e.g., Amihud et al., *supra* note 72, at 270 (“One source of illiquidity is exogenous transaction costs, such as brokerage fees, order-processing costs, or transaction costs.”)(emphasis omitted).

80. Usually auction houses charge the highest fees for the lowest price artworks. For example, an auction house might charge 25% on the first \$20,000, 20% on the amount above \$20,000 and up to \$500,000, and 12% on the amount above \$500,000. MICHAEL FINDLAY, *THE VALUE OF ART* 76 (2012); see also Tara Loader-Wilkinson, *How Art Expenses Stack Up*, WALL ST. J. (Sept.

The costs of maintaining and insuring the piece can cost an additional 1-5% of the value of the piece each year.⁸¹ As a result, art collectors must often wait several years before the price of the piece increases sufficiently to offset the costs of buying, maintaining, insuring, and selling it.⁸² Moreover, the high costs associated with collecting art are not offset by any revenue produced by the artworks before they are sold. Unlike companies that provide dividends to investors or real estate that yields rental payments, art generates no periodic payments for investors. Thus, their investment is essentially completely illiquid for several years, during which time they must expend significant sums to insure and store the pieces.

The illiquidity of art as an asset makes it difficult for art investment vehicles to offer more liquid investment opportunities to investors. Investment funds typically provide greater liquidity to investors in the form of redemption rights,⁸³ the ability for investors to return their shares to the fund in exchange for the cash value of their shares before the termination of the fund.⁸⁴ Indeed, in recent years, some art funds have begun offering limited redemption rights, allowing investors to withdraw up to 5-10% of their investment in the fund each year.⁸⁵ There are significant challenges, however, to providing redemption rights in the context of art funds. In fact, doing so can backfire and undermine the stability and performance of the fund. As explained earlier, artworks often take several years

20, 2010), <http://www.wsj.com/articles/SB10001424052748703959704575453162597091330> [<http://perma.cc/UG2A-NZQ7>] (“At Christie’s or Sotheby’s in New York you can expect to pay an extra 25% on the value of purchases up to \$50,000. Between \$50,000 and \$1 million, a 20% fee is charged, and there is a 12% charge on the portion of the price over \$1 million.”); Sommer, *supra* note 1 (“Auction fees for the buyer can exceed 10 to 20 percent of the hammer price. Other ongoing expenses such as storage, insurance, advisory and appraisal costs may also eat into returns.”).

81. See Loader-Wilkinson, *supra* note 80.

82. See *supra* note 60 and accompanying text.

83. Specifically, hedge funds and mutual funds generally provide investors with redemption rights. Morley, *supra* note 23, at 1235, 1246.

84. *Id.* at 1235.

85. “[S]ince the market crash of 2008, investors have been wary of tying up their money for several years with no get out clause. ‘Art funds by their very nature are illiquid . . . so now we’re seeing more hybrids that resemble a private equity fund in that people aren’t really supposed to be able to come in or out and fees are charged on actual capital raised and profits realised – but at the same time you do allow some limited liquidity; you allow some people to withdraw; maybe 5-10% of the fund in any given year. This helps market the fund to investors: they feel that they are not completely trapped.’” Jenny White, *Art Funds: The Good, the Bad, and the Ugly*, PRIV. ART INVESTOR (Mar. 3, 2015), <http://www.privateartinvestor.com/art-finance/art-funds-the-good-the-bad-and-the-ugly> [<http://perma.cc/5XTP-38K3>].

to sufficiently appreciate to offset transaction and maintenance costs.⁸⁶ That timescale means that funds that are forced to sell works early in their lifecycles are likely to see losses. This is particularly true of works from the secondary market that are bought at the full retail price.⁸⁷ Considering the existing challenge of investor confidence given the limited financial success of past art investment vehicles, losses on initial sales can further undermine investor confidence and potentially lead to a run on the fund, where investors panic and rush to redeem their shares, forcing the fund to prematurely sell its assets and become insolvent.⁸⁸ As a result, the illiquidity of artworks makes it difficult for art investment vehicles to increase the liquidity of their offerings.

Of course, the illiquidity of their offerings does not necessarily doom art investment vehicles. Private equity firms specialize in making illiquid offerings⁸⁹ and have created a large market for such investment opportunities. As of December 2016, private equity firms had nearly \$2.5 trillion in assets under management.⁹⁰ John Morley has argued that private equity firms compensate investors for their lack of exit rights⁹¹ by giving them greater contractual protections.⁹²

86. See *supra* note 59 and accompanying text.

87. As discussed in Section I.B, works on the primary market are often sold at a discount due to the stigma that accompanies a decline in price.

88. A run on the fund occurs when investors lose confidence in a fund and seek to redeem their investments in excess of what the fund has in liquid reserves. Like bank runs, which can happen even to solvent banks, a run on the fund could destroy even potentially profitable funds. See Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 401-03 (1983) (describing the mechanics of a bank run, where “depositors rush to withdraw their deposits because they expect the bank to fail. . . . [T]he sudden withdrawals can force the bank to liquidate many of its assets at a loss and to fail. . . . Illiquidity of assets provides the rationale both for the existence of banks and for their vulnerability to runs”). Since a key feature of funds is limited liquidity, forcing funds to liquidate their assets prematurely can lead to losses, such that they are unable to pay back all of the investors seeking to exercise their redemption rights. If investors see that many other investors are exercising their redemption rights, they might seek to do so as well out of fear that the fund will not be able to return their investment if they wait too long. This creates a positive feedback cycle, such that even investors who originally had confidence in the fund will rationally seek to withdraw their investment.

89. Private equity funds generally do not give investors redemption rights and instead require investors to lock their capital into the fund for the duration of the fund’s life, making these offerings very illiquid. Morley, *supra* note 23, at 1236.

90. Arleen Jacobius, *Private Equity Assets Rise 4% in 2016 – Report*, PENSION & INV. (Mar. 8, 2017), <http://www.pionline.com/article/20170308/ONLINE/170309842/private-equity-assets-rise-4-in-2016-8212-report> [<http://perma.cc/LHN7-TJA5>].

91. Exit rights provide investors with liquidity by allowing them to take their money out of the fund before the end of the fund’s life.

92. Morley, *supra* note 23, at 1255.

Private equity firms increase contractual protections for investors by providing for an investor-elected advisory board along with strong performance incentives for fund managers.⁹³ The contractual protections include mechanisms to address conflicts of interest and to ensure that the fund managers devote a requisite amount of time and resources to each fund.⁹⁴

These contractual protections might be sufficient in more established markets, such as the leveraged buyout or venture capital markets, where investors have seen firms produce significant returns in excess of the market.⁹⁵ However, they do not appear to be sufficient in the still-developing art-fund market, where the returns have not been as well documented or as strong.⁹⁶ A firm's track record is one of the most important factors investors consider when evaluating investment opportunities,⁹⁷ but most art funds are only a couple years old,⁹⁸ and few have successfully exited any prior funds.⁹⁹ As a result, new capital flowing into the art-fund market has largely gone to existing art funds with some track record rather than new ones. In fact, the Fine Art Group accounted for more than \$350 million of the \$557.9 million total amount of assets under management in the

93. *Id.* at 1255, 1257.

94. *Id.* at 1255.

95. Tim Jenkinson et al., *How Do Private Equity Investments Perform Compared to Public Equity?*, 14 J. INV. MGMT. 2 (2016).

96. *See supra* note 41.

97. ERIK SERRANO BERNTSEN & JOHN THOMPSON, *A GUIDE TO STARTING YOUR HEDGE FUND* 120 (2015) (“The perceived experience of a fund manager is one of the most important factors for investors when determining a fund’s attractiveness, and therefore defines the ease with which a fund will be able to raise and maintain capital.”); Steve Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence and Capital Flows*, 60 J. FINANCE 1791, 1821 (2005) (“[P]erformance increases . . . with fund size and with the GP’s experience. . . . [A] GP’s track record is positively related to the GP’s ability to attract capital into new funds.”); Stuart Taylor, *How Investors Can Utilize Performance Track Records To Make Investment Decisions*, 17 J. PRIV. EQUITY 24, 24 (2014) (“[A]nalyzing past performance track records should play an integral role in an investment professional’s due diligence. . . . [P]erformance data . . . confirms the importance of this observation, with significant correlation demonstrated between predecessor and successor fund returns”); Radell, *supra* note 37 (“Among private investment fund insiders, especially on the institutional level, showing a track record of delivering superior returns to investors goes a long way toward attracting new capital. Track record is far more important than ingenious investment philosophies and strategies which, until proven, remain hypothetical.”).

98. Shaw, *supra* note 39 (quoting Philip Hoffman that “[m]ost art funds lack staying power and long-term capital,” and noting that the majority of art funds are less than two years old).

99. The financial crisis led most then-extant art funds to shut down. *See ZORLONI, supra* note 27, at 153.

U.S. and European art-fund markets in 2016.¹⁰⁰ The art-fund market's lack of a significant track record has consequently made it difficult for art funds to attract investors with their illiquid offerings.

Thus, the illiquidity of art as an asset class has made it difficult for art investment vehicles to increase the liquidity of their offerings and attract more investors. Although art funds have made it easier to invest in a diversified portfolio of art, investors in art funds must still keep their money locked in the fund for almost a decade before seeing a return. In addition, art exchanges, which in theory would provide investors with more liquidity through resale rights, have faced regulatory barriers to their creation. As a result, the art investment vehicles that exist in the United States' today are highly illiquid, limiting their attractiveness to investors. Moreover, given that liquidity is a particular concern for less affluent investors,¹⁰¹ the illiquidity of art investment vehicles further limits the accessibility of such vehicles. Illiquidity has thus presented a fundamental barrier, limiting the ability for art investment vehicles to present compelling investment offerings to investors.

B. Misalignment of Incentives Between Art Investment Vehicles and the Primary Market

The challenge art investment vehicles face in accessing quality works on the primary market limits both their potential returns and their ability to expand access to the art market. There are many potential financial benefits for art investment vehicles operating on the primary market – the works are often sold at a discount and are more likely to appreciate on a shorter time horizon.¹⁰² Moreover, given the exclusivity of the primary market, having art investment vehicles take part in this market would expand access to the primary market to a much broader array of investors. This Section will discuss the barriers that art investment vehicles face to becoming players on the primary market.

Within the art market, there is a tension between maximizing the present sale price of a piece of art and cultivating longer-term market confidence in the value of the artist and her body of work. This tension is evident in the very different practices of the primary and secondary markets. On the primary market, where artworks are sold for the first time, galleries take an active role in increasing the long-term value of their artists' oeuvres. In support of this goal, galleries usually provide financial support to artists, actively promote the artists' pieces,

100. Shaw, *supra* note 39.

101. See *supra* note 21.

102. See *supra* notes 63-64; see also *infra* note 106.

and manage the sales of their work.¹⁰³ Works on the primary market are not necessarily sold to the highest bidder. Ideally, artists and galleries try to place their pieces with esteemed museums or reputable collectors, but at a minimum they strive to place pieces with collectors who they think are unlikely to resell the pieces in the near future or who would be willing to resell the pieces back to the gallery rather than to collectors on the secondary market.¹⁰⁴

While this may seem inefficient, actors on the primary market do this to manage the supply and prices of an artist's pieces over time by retaining a monopolist position.¹⁰⁵ Artists and galleries are invested not only in the value of a given piece at a given point in time but in the artist's entire oeuvre over the long term. A boom-and-bust cycle in one of an artist's pieces could damage the value of all of the artist's present and future works. Thus, galleries often intentionally set the initial sale price for a piece below the market price in order to allow it to appreciate gradually over time, rather than risk the possibility that the piece will reach its maximum price too early and then depreciate.¹⁰⁶ Galleries have even been known to buy back their own artists' pieces or bid on them at auctions to protect them from significant declines in price.¹⁰⁷ The incentive of primary market players is thus to maximize the long-term value of the artworks, in part through preventing price declines that could create strong negative signals to collectors, even if doing so involves selling artworks below the market price.

The secondary market, in contrast, generally strives to sell pieces for the highest price possible, regardless of the potential effects on an artist's oeuvre.

103. MAGNUS RESCH, *MANAGEMENT OF ART GALLERIES* 109 (2016).

104. See VELTHUIS, *supra* note 62, at 7, 90-91 (2005); see also *supra* note 66; *infra* note 117.

105. VELTHUIS, *supra* note 62, at 79-83.

106. See HOROWITZ, *supra* note 1, at 176. There is significant stigma around price declines. In a survey of gallerists, one author received responses like "a work of art is never decreased in price, never," "the problem is that if your prices are very high, you cannot go back anymore," and "I have a moral responsibility to maintain the price." Olav Velthuis, *Symbolic Meaning of Prices: Constructing the Value of Contemporary Art in Amsterdam and New York Galleries*, 32 *THEORY & SOC'Y* 181, 191 (2003); see also JAMES HEILBRUN & CHARLES M. GRAY, *THE ECONOMICS OF ART AND CULTURE* 170 (2001) ("For new artists who have yet to establish themselves, a dealer may keep prices low in the first show. A sellout encourages slightly higher prices for a subsequent show."); Allison Schragger, *High-End Art Is One of the Most Manipulated Markets in the World*, *QUARTZ* (July 11, 2013), <http://qz.com/103091/high-end-art-is-one-of-the-most-manipulated-markets-in-the-world> [<http://perma.cc/4MSX-ZSJA>] ("Galleries may drop an artist rather than lower the price of their work because doing so sends a bad signal about the value of the artist and the credibility of the gallery."); Velthuis, *supra*, at 196 ("The dramatic consequences of price decreases on the collector's appraisal generate an incentive for art dealers to start low and increase prices only cautiously.").

107. Schragger, *supra* note 106 ("It is not uncommon for gallery owners to bid on their artists[] work at the auction in order to control the market price.").

Unlike the primary market, connections and reputation are not prerequisites for bidding at auctions in the secondary market. Instead, auctions are usually open to the public, and pieces go to the highest bidder. Moreover, instead of artificially low prices, the secondary market can suffer from artificially high prices as a result of the winner's curse.¹⁰⁸ The idea behind the winner's curse is that the winner of a common value auction¹⁰⁹ with incomplete information is likely to overpay.¹¹⁰ When there is an objective valuation for how much an artwork is worth but uncertainty about this valuation, the person who bid the highest amount, i.e. won the auction, is likely to have overestimated the value of the work. This phenomenon is not a general condemnation of the art auction market given that art auctions are arguably not common value auctions – the bidders have very different subjective valuations for the artwork.¹¹¹ If a collector would enjoy the artwork far more than any of the other bidders, the collector has arguably not overpaid for the artwork by bidding more than anyone else. The issue, however, is that art investment vehicles are not buying artworks for their consumption value but rather for their resale value, so for the art investment vehicle, the auction is more akin to a common value auction.¹¹² Thus, if an art investment vehicle wins an auction, i.e. bids more for the artwork than anyone else is willing to pay, the art investment vehicle is likely to have made a poor bet. Indeed, some studies have found evidence for a winner's curse in the art market.¹¹³ As a result, there is often

108. See *infra* note 113.

109. Common-value auctions are “auctions where the value of the item is the same to everyone but different bidders have different estimates about the underlying value.” John H. Kagel & Dan Levin, *Common Value Auctions and the Winner's Curse: Lessons from the Economics Laboratory 1* (2001), <http://www.econ.ohio-state.edu/kagel/CVsurvey.short.PDF> [<http://perma.cc/3UFS-AMBT>].

110. John H. Kagel & Dan Levin, *The Winner's Curse and Public Information in Common Value Auctions*, 76 *AMERICAN ECON. REV.* 894 (1986).

111. William N. Goetzmann & Matthew Spiegel, *Private Value Components, and the Winner's Curse in an Art Index*, 39 *EURO. ECON. REV.* 549, 550 (1995).

112. The common value in this case is the resale value. Everyone in the auction is trying to guess what the resale value of the work will be, and since this is a question of prediction, there is a single correct answer (unlike the case where people are bidding in part based on their personal enjoyment of the work, such that there is not a single true value of the artwork).

113. See, e.g., Roman Kräussl & Elizaveta Mirgorodskaya, *The Winner's Curse on Art Markets* (Ctr. for Fin. Studies, Working Paper No. 564,2016); Goetzmann & Spiegel, *supra* note 111, at 549.

a significant gap between the prices of pieces on the primary market and on the secondary market, with the latter exceeding the former.¹¹⁴

In order to prevent arbitrage between the primary and secondary markets, galleries are selective about their clientele. Collectors who develop a reputation for “flipping” pieces, or buying them only to quickly resell them on the secondary market for a higher price, may be barred from buying pieces on the primary market.¹¹⁵ This creates a misalignment between the goals of primary market players and art investment vehicles. Primary art market players, such as galleries, aim to restrict how and when pieces are sold. While art investment vehicles would like to sell works at peak prices, galleries and dealers strive to prevent artworks from being sold at inflated prices on the secondary market out of fear that the prices will subsequently decline or the works will fail to sell in the future.¹¹⁶ Thus, from the perspective of galleries, there is little incentive to sell their best works to art investment vehicles since they do not provide the reputational benefits of a placement with a prestigious collector and might sell a work prematurely. In fact, the ability of collectors to gain access to top galleries and artists often depends on collectors’ assurances to galleries that they will not resell works prematurely or on the secondary market.¹¹⁷

114. For example, in December 1999, Andreas Gursky’s photographs sold out on the primary market (a commercial New York gallery) for \$50,000 per item. Two weeks earlier, a 1995 photograph of his was purchased on the secondary market (Christie’s New York) for \$173,000. HOROWITZ, *supra* note 1, at 175.

115. See *id.* at 176; *New or Secondhand?: The Ins and Outs of Primary and Secondary Markets*, ECONOMIST (2009), <http://www.economist.com/node/14941173> [<http://perma.cc/FD27-Z55W>] (“Collectors who ‘flip’ work at auction may have their privileges [to buy pieces from select artists] withdrawn or find themselves excluded from the gallerist’s coterie.”). Many important galleries have blacklisted prominent art speculator Stefan Simchowitz. Christopher Glazek, *The Art World’s Patron Satan*, N.Y. TIMES (Dec. 30, 2014), <http://www.nytimes.com/2015/01/04/magazine/the-art-worlds-patron-satan.html> [<http://perma.cc/SS9E-UQ8X>]. Another article reported on a young art collector who bought a work and was offered fifty times the purchase price a few weeks later. The collector refused, however, since “reselling it at a profit without the gallery’s permission would blackball her from the art industry. To her, that was not worth the millions she was offered.” Schragar, *supra* note 106.

116. *She Can’t Be Bought*, N.Y. MAG., <http://nymag.com/nymetro/arts/art/11265/index1.html> [<http://perma.cc/U23F-LHCC>] (“Galleries often make clients promise not to resell work at auction, arguing that it can put an artist’s career (and the gallery’s investment in that career) at risk if the piece fails to sell. Conversely if it sells for too much, other collectors may be inspired to dump work by the same artist at auction with similarly unpredictable results.”).

117. Schragar, *supra* note 106 (“Galleries [] want to know the buyer in order to keep track of the work. That way they can ensure it’s available for exhibitions in the future and that it won’t be sold on the secondary auction market. Control over the market is so important to galleries that they won’t sell to collectors who will flip the art in the secondary market.”); *She Can’t Be Bought*, *supra* note 116 (describing how galleries and dealers carefully decide who to “place”

From the art investment vehicle's perspective, these mechanisms also make operating on the primary market less attractive. The primary market's restrictions on when and to whom collectors can sell their works create a tension between access to the primary market and maximizing liquidity. In order to give galleries assurances that they will not sell pieces either when the price of the piece goes down or is excessively inflated and that they will not sell pieces to undesirable speculators, art investment vehicles would significantly constrain the conditions under which they could liquidate their holdings and also limit the positive financial returns they could derive.

Thus, in order for art investment vehicles to leverage the benefits of the primary art market and expand investor access to this market, the incentives for cooperation between galleries and art funds will have to change. Section II.B will discuss proposals to better align the incentives between art investment vehicles and primary market players through contractual arrangements that give galleries greater control over when pieces are sold and allow them to profit from such sales without overly constraining the liquidity of art investment vehicles.

C. Securities Regulation Constraints

Finally, certain securities regulations hamper the successful operation of art exchanges in the United States. The key differences between art funds and art exchanges are that art exchanges have low or no barriers to entry for investors and enable investors to easily resell their shares to other investors. Because of these distinctions, art exchanges are able to offer investors much more liquid and accessible investment opportunities than art funds.

The key reason that art funds do not provide these seemingly attractive features is that, like other private equity and hedge funds, they use the security exemption under Rule 506 of Regulation D¹¹⁸ to avoid registering their offerings with the Securities and Exchange Commission (SEC). Registering a securities offering with the SEC is an expensive process that requires extensive and ongoing disclosures to the Agency.¹¹⁹ In order to avoid having to register their offerings, issuers must comply with restrictions depending on the type of exemption

works with as a way of “controlling what happens to art after they’ve parted with it – hence, of manipulating its value,” how “dealers really don’t want to see . . . a work get flipped at auction,” and how “[d]ealers prefer that owners come back to them with works to resell, privately”).

118. 17 C.F.R. § 230.506 (2017).

119. A study by PricewaterhouseCoopers found that in addition to underwriting fees of 5-7% of gross proceeds, companies on average incur \$3.7 million in costs directly attributable to their IPO and over \$1 million in one-time costs as a result of going public. *Considering an IPO? The*

they use. Rule 506 limits the ability of unaccredited investors¹²⁰ to invest and restricts the resale rights that can be given to investors—that is, the ability of investors to sell their shares to other investors.¹²¹ Under Rule 506, investors must be given restricted securities, which can only be resold under specific conditions. In order to sell restricted securities without having to register the offering, investors must comply with Rule 144,¹²² which requires them to hold the

Costs of Going and Being Public May Surprise You, PwC 4 (2012), http://www.strategyand.pwc.com/media/file/Strategyand_Considering-an-IPO.pdf [<http://perma.cc/TP8N-WCWF>]. The study also found that companies on average incur \$1.5 million in recurring costs as a result of being public. *Id.* A government task force estimated the costs of going public at \$2.5 million on average and the costs of staying public at \$1.5 on average annually. IPO Task Force, *Rebuilding the IPO On-Ramp: Putting Emerging Companies and the Job Market Back on the Road to Growth*, U.S. SEC. & EXCHANGE COMMISSION 9 (Oct. 20, 2011), http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf [<http://perma.cc/6Y5G-UDM2>]. In addition to the direct costs of the registration process, the process is also very time intensive, taking around 75% of the CFO's time, 40% of the CEO's time, and 20% of the time of other senior officers. JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 152 (7th ed. 2013).

120. For the definition of an accredited investor, see *supra* note 70.
121. 17 C.F.R. § 230.506. Under Rule 506(b), a “company may sell its securities to an unlimited number of ‘accredited investors’ and up to 35 other purchasers.” *Rule 506 of Regulation D*, U.S. SEC. & EXCHANGE COMMISSION (Oct. 4, 2014), <http://www.sec.gov/fast-answers/answers-rule506htm.html> [<http://perma.cc/N7FG-GDAA>]. These other purchasers must still be “sophisticated,” however. *Id.* In addition, a company accepting unaccredited investors cannot conduct general solicitations, and must provide any unaccredited investors with the disclosure documents that usually accompany registered offerings and any other documents it gives to accredited investors. *Id.* It also must be available to answer questions by prospective buyers. Under Rule 506(c), the fund can broadly solicit and generally advertise the offering but must limit itself to accredited investors and take reasonable steps to verify each investor’s status. *Id.*
122. 17 C.F.R. § 230.144 (2017). Investors in art investment vehicles would generally be considered non-affiliates to a nonreporting company. Affiliates are people who directly or indirectly control the entity in question. *Id.* § 230.405. For example, they include executive officers, directors, and large shareholders of the entity issuing the security. *Rule 144: Selling Restricted and Control Securities*, U.S. SEC. & EXCHANGE COMMISSION [hereinafter *Rule 144*] (Jan. 16, 2013), <http://www.sec.gov/reportspubs/investor-publications/investorpubsrule144htm.html> [<http://perma.cc/A8N5-NNBU>]. The investors in art investment vehicles with which this Comment is concerned are those who are passively contributing money to the art investment vehicle rather than owning/controlling it. Reporting companies are companies that are subject to Section 13 or 15(d) of the Exchange Act, which would happen if the company is listed on a public stock exchange, if it has total assets greater than \$10 million and a class of equity securities held by 2,000 or more people or 500 or more non-accredited investors, or if it has issued public equity. COX ET AL, *supra* note 119, at 10. The art investment vehicles discussed in this piece only conduct private offerings and are generally not large enough to trigger these reporting requirements. Another safe harbor that allows investors to sell their restricted shares without registering the sale with the SEC is Rule 144A. 17 C.F.R. § 230.144A (2017). This

securities for at least one year.¹²³ The investor must also gain the consent of the fund to sell the security and have an intermediary called a transfer agent¹²⁴ remove the restrictive legend (a statement on the security stating that it is a restricted security) on the security.¹²⁵

Given these restrictions on who can invest in private funds and the ability of private fund investors to sell their shares, the art exchange model in the United States has required the entities to be public.¹²⁶ The advantage of making an investment vehicle public is that the securities are traded on the public market, meaning that anyone can invest and investors can easily resell their shares to other investors.¹²⁷ However, as discussed above, going public entails high initial and ongoing regulatory compliance costs.¹²⁸ Given the relatively small size of the art investment vehicle market and limited financial success to date, raising sufficient capital to make creating a public investment offering a viable option would be challenging.

However, recent securities regulation reforms offer the potential to facilitate the creation of art exchanges. Section II.C discusses two options created by these changes through which art investment vehicles could achieve the benefits of low barriers to entry and robust resale rights for investors while avoiding the large costs associated with public offerings.

exemption, however, only applies to sales to qualified institutional investors, which are defined as large institutional investors with at least \$100 million in assets. *Id.* at §230.144A (a)(1)(i). Given the very limited involvement of large institutional investors in the art investment vehicle market, however, this exemption is not likely applicable.

123. 17 C.F.R. § 230.144(d)(1)(ii).

124. A transfer agent is defined as “any person who engages on behalf of an issuer of securities . . . in (A) countersigning such securities upon issuance; (B) monitoring the issuance of such securities with a view to preventing unauthorized issuance . . . (C) registering the transfer of such securities; (D) exchanging or converting such securities; or (E) transferring record ownership of securities by bookkeeping entry . . .” 15 U.S.C § 78c(a)(25) (2012).

125. *Rule 144*, *supra* note 122. This process can add delays to the transfer and often requires the investor to obtain a legal opinion stating that registration is not required. COX ET AL., *supra* note 119, at 374.

126. Liquid Rarity Exchange, the primary example of an art exchange attempted in the United States, planned to serve as a platform for “publicly traded shares of securitized art.” Curley, *supra* note 28.

127. “In a registered offering, issuers can offer the securities directly to all potential investors, without a limitation on the aggregate offering amount and with no resale restrictions.” *Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A)*, SEC. & EXCHANGE COMMISSION 244, <http://www.sec.gov/rules/final/2015/33-9741.pdf> [<http://perma.cc/V5VM-BZFM>].

128. See *supra* note 119 and accompanying text.

II. UNLOCKING THE POTENTIAL OF ART INVESTMENT VEHICLES

This Part details three proposals that could address the challenges described above. First, to increase liquidity and potential returns, art investment vehicles should strive to create a robust art rental market that will allow them to profit not only from the resale value of artworks but also their aesthetic value. Creating a vibrant rental market would transform art from a cash-flow-negative asset to a cash-flow-positive asset. Instead of causing investors losses throughout the investment period due to storage and insurance costs, the artworks would actually generate profits, increasing the amount of liquid cash available to art investment vehicles to distribute to investors in the form of dividends or redemption rights.

Second, well-designed contractual arrangements could open the primary art market to art investment vehicles: by creating arrangements that allow galleries to retain equity in the pieces they sell to art investment vehicles and that limit how and when art investment vehicles can resell pieces, galleries would be incentivized to provide high-quality works to art investment vehicles, as they would both incur lower transaction costs than if they were to evaluate individual collectors and profit when the works are resold for higher prices. These restrictions on the conditions of resale would allay galleries' and artists' concerns that art investment vehicles would engage in arbitrage without unduly restricting the investment vehicle's ability to resell the piece of artwork when desired. Allowing galleries to retain equity in works they sell to art investment vehicles would also align the interests of galleries and art investment vehicles by incentivizing galleries to provide their top works to art investment vehicles. Expanding the access of art investment vehicles to the primary market would not only potentially improve the returns of art investment vehicles but also give access to this exclusive segment of the art market to less-established investors.

Third, art exchanges can leverage recent regulatory developments in the United States. The securities registration exemptions created by Regulation Crowdfunding¹²⁹ and Regulation A+¹³⁰ provide a way for art exchanges to form without facing the prohibitively high costs of making public offerings. By characterizing art management companies as startups, art management companies could sell equity on an art exchange that would essentially function as a crowdfunding platform. The new regulations would allow these platforms to sell shares with resale rights to a much broader array of investors.

¹²⁹. 17 C.F.R. § 227 (2017).

¹³⁰. 17 C.F.R. § 230.251-263 (2017).

A. *Creating a Robust Art Rental Market*

One of the key features of art investment vehicles is that they separate the aesthetic value of a piece of artwork from its investment value. Whereas art collection typically bundles the ability to possess and enjoy the piece with the ability to sell and profit from it, art investment vehicles give investors access to the investment value of a piece without necessarily giving them access to the physical piece itself. Although some art funds provide opportunities for their investors to rent pieces from the fund, artworks owned by art funds are primarily kept in storage.¹³¹ Moreover, while some companies have created an art rental market for lower-end art,¹³² as of yet there is no large, public marketplace for high-end art rental.

By renting out their artworks, art investment vehicles could increase the liquidity and potential returns of their offerings. By generating income from rentals, art investment vehicles would not need to hold artworks for as long of a time in order to have the artwork's appreciation offset the maintenance and transaction costs—the revenue would at least partially offset these costs. In addition, art rental would increase the data available regarding the potential financial value of the artworks, making them less risky investments and expanding the pool of potential investors. Since liquidity reflects the ability to quickly find a buyer who is willing to pay a given price for the asset, making the prices for artworks more tethered to objective considerations—the net present value of art rental payments instead of one's personal subjective appreciation for the artwork—would enhance the liquidity of the artworks.

Moreover, in the absence of a robust rental market, the artwork's aesthetic value is wasted: no one gets to enjoy the artwork. Indeed, one of the negative consequences of the rising interest in art investing is the growing use of art storage.¹³³ Art rental would not only turn these assets from being cash flow negative

131. See *supra* note 25.

132. See, e.g., RISE ART, <http://www.riseart.com> [<http://perma.cc/U4GW-F4AR>]; TURNING ART <http://www.turningart.com> [<http://perma.cc/VW3B-4DK9>]. The works on these platforms are primarily for decorative rather than investment purposes.

133. See Foulkes, *supra* note 25; Cynthia O'Murchu, *Art: A Market Laid Bare*, FIN. TIMES (Apr. 7, 2015), <http://www.ft.com/intl/cms/s/2/a91a1608-d887-11e4-8a23-00144feab7de.html> [<http://perma.cc/39RM-RWMZ>]; David Segal, *Swiss Freeports Are Home for a Growing Treasury of Art*, N.Y. TIMES (July 21, 2012), <http://www.nytimes.com/2012/07/22/business/swiss-freeports-are-home-for-a-growing-treasury-of-art.html> [<http://perma.cc/F3SQ-K9CL>]; Sharon V. Thach & Kimball R. Marshall, *An Illustration of Opaque Markets: High End Fine Art 7-8* (2016), http://ssrn.com/abstract_id=2733153 [<http://perma.cc/3JS3-697H>] (describing how the trend of collecting art “not for display, but purely as a store of value” has led to the expansion of the art storage industry). Even Christie's is making a long-term investment in

to cash flow positive, but would also make it more affordable for people to enjoy fine art in their homes or public venues. Robust rental markets would also expose a wider audience to the piece, which could increase the work's value if it is well received.

To illustrate the potential value that can be created by leveraging both the full aesthetic and investment values of artworks, let us posit a collector *A* and a speculator *B*. *A* values the enjoyment she receives from hanging a piece in her home for a decade at \$10,000 and she does not intend to sell the piece.¹³⁴ Speculator *B* does not value the aesthetics of the piece and would put it in storage immediately, but believes that he will be able to sell the work for \$10,000 in the future. Let us also posit an investor *C* who values the aesthetic enjoyment of the piece at \$5,500 and projects that she will be able to resell it in a decade for \$5,500, making her total valuation of the piece \$11,000. If only one investor can purchase the piece, then, ignoring the time value of money, the piece will go to *C* for \$10,001. Assuming for the sake of simplicity that the artist did not have costs associated with the creation of the artwork, the artist would receive \$10,001 of producer surplus, and *C* would receive \$999 of utility in the form of consumer surplus, for a total gain of \$11,000. This outcome, however, is suboptimal from the perspective of maximizing overall utility.

A scenario that would result in greater utility would be for *A* to buy the right to possess the physical art piece for \$5,501, and *B* to buy the resale rights to the piece for \$5,501. *A* would take the piece home and enjoy \$10,000 of value, which would result in \$4,499 in consumer surplus. If *B*'s predictions are accurate (that the piece can be resold for \$10,000 in ten years), when the piece is resold, *B* will make a profit of \$4,499. In this scenario, the artist would make more than in the previous scenario (\$11,002 rather than \$10,001), and the total consumer surplus is \$8,998, so the total surplus value from this transaction is \$20,000.¹³⁵ This is

the continued growth of the art storage market by expanding its storage offerings in London and building a new facility at the Singapore Freeport. Marion Maneker, *The Boom in Art Storage: Christie's View*, ART MKT. MONITOR (June 29, 2009), <http://www.artmarketmonitor.com/2009/06/29/the-boom-in-art-storage-christies-view> [<http://perma.cc/NR9R-CNGV>].

134. Realistically, there are probably very few art buyers who would value the resale rights of an art piece at \$0. Nonetheless, one could conceive of collectors who do not intend to sell the piece in their lifetime (and who derive zero utility from the possibility that their heirs might sell the piece—perhaps they are not particularly fond of them), or even collectors who derive so much negative utility from the process of selling a piece that on net they do not benefit from the resale.

135. Note that, in a denser market, where the parties were forced to pay their willingness-to-pay, the artist would be able to capture all of the value created by the more efficient allocation. For example, suppose that there also is an art collector *D* who values the aesthetic returns of the piece at \$9,999 and an art speculator *E* who values the resale rights at \$9,999. In this case, *A* would buy the right to possess the physical piece for \$10,000, and *B* would buy the resale

far more total utility than what was achieved when only one individual could purchase the financial and aesthetic value of the piece (i.e., \$11,000). As this example demonstrates, through more efficiently allocating the aesthetic and investment values of the artwork, far more utility can be achieved.

Separating the aesthetic and investment values of a piece of artwork and allocating each to the highest value user is something that art investment vehicles are uniquely designed to do. A core feature of art investment vehicles is that because there are many “owners” of the artworks, no owner has full possession over the physical artwork. Although this is a negative feature of existing art investment vehicles – the artworks are generally kept in storage rather than enjoyed by anyone – this feature could be leveraged to give art lovers greater access to artworks in their homes. By creating a robust art rental market, art investment vehicles could increase the total value extracted from the art market and also enhance their own profitability. Instead of having artworks sit in storage, only to be liquidated after several years, renting out the artworks would give the art investment vehicle greater access to capital and shift some of the costs of maintaining the artworks to the renters.

Art rental could also lead to more transparent and reliable pricing of artworks. Artworks can be rented far more frequently than they can be sold. The amount that individuals are willing to pay to rent them would provide more data about market demand, making it easier to accurately estimate the net present value of an artwork. Given how little data is available about prices on the art market, such data could be quite valuable.¹³⁶ Art price indices often rely on tracking price changes in individual works that have been sold at auction more than once.¹³⁷ This method is not very reliable, however, given how infrequently works go up for auction.¹³⁸ In contrast, one method for valuing real estate, another relatively illiquid asset that is sold infrequently, is the income method, which estimates the value of a piece of real estate as the net present value of future rental

rights for \$10,000. The artist in this scenario would receive \$20,000 for the piece, far exceeding the \$11,000 she would receive if only one investor could buy the piece.

136. Existing art databases charge steep fees for searches and generally only feature auction sales data. Since auctions account for at most half of the market (primary market sales do not occur through auctions), the amount of information available for any given piece or subset of pieces is very limited. GERLIS, *supra* note 57, at 32 (describing how artnet has the one of the most comprehensive databases of art sales prices available and charges \$976 for 450 individual sale searches in 2013).
137. Radell, *supra* note 37 (describing the repeat sales regression approach used to construct the Mei Moses All Art Index).
138. *Id.* (describing how “[t]he primary problem with applying repeat sales regression to art data is the paucity of available information” and the issues of selection bias).

payments, using past rental data to inform this estimate.¹³⁹ The availability of art rental data would thus allow a similar methodology to be used in the art world¹⁴⁰ and would give potential buyers more data about how much the piece is worth. More transparent and reliable pricing would in turn increase liquidity in the market as buyers could have greater assurances regarding the value of the piece, taking some of the subjectivity out of art pricing and making it easier for sellers to quickly sell pieces at a stable price. Moreover, by providing more frequent objective signals of the artwork's value, the rental data might help mitigate the potential for rampant speculation, a problem that has plagued Chinese art exchanges.¹⁴¹ Instead of simply guessing at the potential resale value of an artwork, investors would have more access to concrete data on how much money people are willing to spend on the artwork.

Despite these advantages, renting out high-end art is risky. The process of renting itself might lead to depreciation of the piece if renters do not properly care for the piece or if the work is damaged in transit. Costs to insure the piece would thus likely increase significantly. Moreover, artists have rights that could be violated if works are damaged. Artists' moral rights include the right to prevent any intentional distortion, mutilation, or other modification of the work.¹⁴² In order to mitigate these issues, the art investment vehicle should therefore carefully vet renters and place restrictions on where and how the artwork can be displayed.

Despite these challenges, a rental market for high-end art has several benefits: establishing a rental market for art owned by art investment vehicles would increase efficiency in the art world by allocating the aesthetic and investment

139. Stephan Abraham, *Rental Properties: 4 Ways to Value a Real Estate Property*, INVESTOPEDIA (Feb. 8, 2017, 10:02 AM), <http://www.investopedia.com/articles/mortgages-real-estate/11/how-to-value-real-estate-rental.asp> [<http://perma.cc/7UAAU-828P>].

140. Noah Horowitz, a prominent art historian and expert, has made the point that it is common in real estate and equity markets to estimate the value of an asset based on the discounted value of its future cash flows, but this is far more difficult in the context of art, given that art generally is a cash flow negative asset. HOROWITZ, *supra* note 1, at 170.

141. *See supra* notes 49-50 and accompanying text.

142. Visual Artists Rights Act of 1990 § 603(a), 17 U.S.C. § 106A(a)(3) (2012). Note that there are some limitations on this "integrity right": the change in the work must be prejudicial to the artist's reputation, the right is nontransferable, and the right only applies to works by living artists. *Id.* § 603(a)(3), (c). Moreover, the protection only applies to "works of visual art" and only encompasses limited edition works of 200 copies or fewer. *Id.* § 101. The right of integrity allows artists to sue for an injunction or damages. Henry Hansmann & Marina Santilli, *Authors' and Artists' Moral Rights: A Comparative Legal and Economic Analysis*, 26 J. LEGAL STUD. 95, 118 (1997). The Visual Artists Rights Act permits courts to assess statutory damages that exceed actual injuries provable by the plaintiff. *Id.* at 124.

values of artworks to the highest-value users and potentially lead to higher returns for art investment vehicles. The cash flow from rentals would also put art investment vehicles in a better position to offer investors more liquidity through dividends and/or redemption rights. Moreover, art rental would also make accessing high-end artworks more accessible for those who are unable to buy entire pieces. Thus, the natural separation of the aesthetic and investment values of artworks that occurs with art investment vehicles could be leveraged to increase the potential returns and liquidity of art investment vehicles and to increase the accessibility of high-end art by creating a robust art rental market.

B. Gaining Access to the Primary Market

As discussed in Section I.B, the primary and secondary art markets are governed by different players and customs.¹⁴³ While the secondary market operates on standard open market principles, the primary market attempts to distinguish between collectors and speculators in order to exclude speculators. This need to distinguish between types of buyers leads to substantial transaction costs for both buyers and sellers. Buyers must invest in signaling to show that they are reliable art collectors. For example, they must foster connections with galleries and dealers and keep their acquisitions off the secondary market even if doing so means reducing the liquidity of their holdings and forgoing higher sale prices.¹⁴⁴ Unlike in most markets, art sellers cannot rely on willingness to pay as a proxy for buyer suitability.¹⁴⁵ This is particularly true as there may be a positive correlation between the likelihood that a buyer is a speculator and that buyer's willingness to pay: a buyer is likely to pay more if the buyer anticipates profiting from the artwork in the short term. Thus, reputation and connections are necessary factors in determining buyer suitability.¹⁴⁶

This selectiveness of clientele excludes not only less-established collectors from the primary market but also art investment vehicles. In general, the qualities in buyers that primary market players look for are distinct from those found in art investment vehicles. Even if the managers of art investment vehicles have good reputations and connections in the art world, the primary goal of art investment vehicles is to sell their artworks at the maximum price possible, within the lifespan of the investment vehicle. This makes art investment vehicles akin

143. See *supra* Section I.B.

144. See *supra* note 104.

145. "Good galleries . . . sell works they consider important only to people or institutions they consider appropriate buyers. Very often at the expense of near-term cashflows." Gerber, *supra* note 63, at 7; *New or Secondhand*, *supra* note 115 ("In the primary market, the collector who offers the most money is not necessarily the one who wins the work.").

146. VELTHUIS, *supra* note 62, at 90.

to speculators and puts the interests of the investors in direct conflict with the interests of the galleries and artists.

Both art investment vehicles and primary market players could benefit, however, from transacting with each other. As discussed above, art investment vehicles stand to benefit financially from buying top works on the primary market since these works are generally sold at a discount compared with works on the secondary market and have the potential to appreciate more significantly on shorter time horizons. As a result, investing on the primary market could give art investment vehicles access to higher returns, and they would not have to hold onto pieces as long to see a positive return. Moreover, since the primary market is currently limited to art world insiders, operating on the primary market would allow art investment vehicles to give a much broader array of investors access to this market.

Galleries stand to benefit from selling to art investment vehicles in that doing so would require lower transaction costs than vetting individual collectors – art investment vehicles have much larger collections than most individual collectors and are generally repeat players. Moreover, art investment vehicles are uniquely situated to allow galleries to retain equity in their top works. Currently, when galleries sell their works at a discount to collectors, they forgo some potential income in the present in the hope that the piece will appreciate over time, the artist's reputation will improve, and the future works of the artist will sell at higher prices, increasing their long-term returns. If galleries could retain equity in the pieces they sold, however, they could receive more direct financial benefits from future appreciation in these works' prices. While individual collectors buy pieces outright, art investment vehicles have the ability to divide ownership in artworks among multiple parties. Having the gallery retain equity in the piece would not only give the gallery access to this future profit stream, but would also incentivize the gallery to provide art investment vehicles with top works that it believes are likely to appreciate.

In order to create such mutually beneficial arrangements between primary market players and art investment vehicles, however, it is important to resolve the issue of when and how pieces sold to art investment vehicles can be resold. In cases where there is sensitivity around future purchasers of an asset, rights of first refusal are a common contractual provision.¹⁴⁷ In the context of companies,

147. Albert H. Choi, *A Rent Extraction Theory of Right of First Refusal*, 57 J. INDUS. ECON. 252, 253 (2009) (“[T]he usage of right of first refusal is wide-spread: it is seen not only in lease agreements, but also in joint venture agreements, sale and lease-back agreements, venture capital financing, bylaws of small corporations and partnerships, oil and gas sale agreements, em-

rights of first refusal require that the shareholders offer to sell their shares to their fellow shareholders before selling the shares to third parties.¹⁴⁸ The purpose of such a provision is to protect existing shareholders' interests in being able to determine who has ownership rights in the company.¹⁴⁹ Given that galleries similarly want to control to whom their pieces are resold—for example, they want to prevent their works from being sold to speculators—a right of first refusal could potentially alleviate some of these concerns. Moreover, to the extent that the gallery is willing to buy back the artwork, the gallery could retain control of when the piece is sold by preventing untimely resales. In fact, rights of first refusal are already used occasionally by galleries when working with individual collectors.¹⁵⁰

One potential issue with a right of first refusal arrangement, however, is that if the piece really is at the crest of a speculative bubble, the gallery might not have sufficient capital to pay the market price. Most galleries have very limited working capital.¹⁵¹ One possible way to address this issue would be to give the gallery a right of first refusal where the gallery has the option to buy the piece back at the initial sales price plus a negotiated interest rate if the price of the work increases, or at the initial sales price if the price of the work decreases. The advantage of this arrangement for the gallery would be that if the artwork were in a bubble and increased dramatically in price, exceeding the sales price plus interest, the gallery could buy it back at a lower price. The advantage for the art investment vehicle would be that in the event the artwork actually declined in price, such that the gallery would want to buy back the piece to avoid the negative price signal, the art investment vehicle would not lose any money. If the price of the work increased but was not exhibiting unsustainable bubble-like prices, the gallery would likely allow the sale to a third party. This arrangement would

ployment contracts, broadcasting agreements, and even contracts involving commercial products. A frequently offered justification is that the right minimizes the possibility of the right-holder's having to face a new, undesirable partner in a relationship.”).

148. See Walker, *supra* note 73, at 1.

149. *Id.* at 19 (describing how rights of first refusal are often used in contexts where insiders place idiosyncratic value on the property and how, in the close corporation context, insiders might value maintaining control).

150. See Amy J. Goldrich, *Is a Right of First Refusal an Offer You Can't Refuse? If It's in Writing, Most Probably*, 2 SPENCER'S ART L.J. (2011), <http://www.artnet.com/magazine/news/spencer/spencers-art-law-journal-9-2-11.asp> [<http://perma.cc/6TE5-SUBM>]; *Are Contemporary Dealers Too Powerful?*, FORBES (July 5, 2005, 12:01 AM), http://www.forbes.com/2005/07/05/cx_0705conn_ls.html [<http://perma.cc/J3ZT-K2JA>].

151. Despite the media stereotype of the art world being flush with cash, a third of galleries are operating at a loss, and half make less than \$200,000 in annual revenue. RESCH, *supra* note 103, at 24-26.

be most beneficial if the gallery were more worried about the potential for speculative bubbles than the potential of price declines and if the art investment vehicle were more worried about the possibility of losing money than the possibility of not maximizing their profits in the event their investment goes very well. Under those circumstances, this arrangement would essentially help both parties avoid their respective worst outcomes.

Another potential issue to address is that rights of first refusal have been linked with lower asset prices.¹⁵² If an asset has a right of first refusal connected to it, the seller can have a harder time getting competitive bids for the asset since potential bidders know that there is a good chance they will not be able to buy the asset—i.e., the right of first refusal will be exercised. To mitigate this issue, the right of first refusal could be limited to an initial holding period, after which the art investment vehicle would be free to sell the piece to third parties without first offering it to the gallery. This would encourage the art investment vehicle to hold onto the piece for at least the holding period but would also give the art investment vehicle more flexibility to sell the work to third parties. By combining the right of first refusal plus interest model discussed above with a minimum holding period, the concerns that primary-market players have regarding the potential for art investment vehicles to sell artworks at an unfavorable time or to an unfavorable collector can be mitigated while not unduly restricting the liquidity of art investment vehicles.

Of course, since this proposed arrangement is a compromise, the optimal holding period and interest rate would depend on an array of factors, including the forecasts of the art investment vehicle and the gallerist regarding the future value of the piece, the other potential buyers in the market, and the costs associated with implementing more complex arrangements. This proposal, however, gives both parties levers to pull to make the arrangement better conform to their particular preferences and circumstances, assisting the parties to negotiate mutually beneficial partnerships.

Thus, although the primary market's careful avoidance of speculative investment would suggest that art investment vehicles are ill suited for that market, the ability of art investment vehicles to provide different rights to different parties and to allow primary-market players to retain rights in artworks actually creates significant potential for art investment vehicles to benefit primary-market players and vice versa. Such partnerships could improve the potential investment returns of art investment vehicles by giving them access to the lucrative

152. See Walker, *supra* note 73, at 3 (“Rights of first refusal discourage potentially high-valuing third-party bidders from entering a contest to purchase, and thus the instrument reduces a seller’s expected realization.”).

primary market while opening up investment in the highly exclusive primary market to a broader array of investors.

C. Leveraging Recent Securities Law Reforms To Create Art Exchanges

While the previous proposals address the issues of liquidity and accessibility in the art market indirectly by creating new liquid or lucrative revenue streams, giving more people access to art in their homes, or making it easier to invest in the exclusive primary market, art exchanges would directly increase the accessibility and liquidity of art investment vehicles themselves. Unlike art funds, art exchanges allow investors to easily sell their shares rather than have their capital locked away for years. Moreover, art exchanges do not require a large capital commitment, allowing less wealthy investors to participate in the art market. Nonetheless, despite such benefits, almost all of the art investment vehicles in the United States have been formed as art funds, not as art exchanges. Regulatory constraints on the creation of art exchanges have made them prohibitively expensive due to two key characteristics of art exchanges: they are completely open to unaccredited investors and they allow investors to buy and sell their shares easily.

However, recent changes in the regulatory landscape have made these obstacles less significant. Regulation Crowdfunding,¹⁵³ an exemption from registering with the SEC that was established by Title III of the Jumpstart Our Business Startups (JOBS) Act, and Regulation A+,¹⁵⁴ the amended version of Regulation A, established by Title IV of the JOBS Act, have created new possibilities for art exchanges in the United States.

Regulation Crowdfunding is an exemption that allows small companies to raise funds from unaccredited investors through broker-dealers¹⁵⁵ or funding platforms.¹⁵⁶ Funding platforms are essentially intermediaries in the transactions; they are websites or mobile apps where investors create accounts, review

153. 17 C.F.R. § 227 (2017).

154. 17 C.F.R. §§ 230.251-263 (2017). Regulation A+ builds upon the previously existing Regulation A. See COX ET AL., *supra* note 119, at 322.

155. Broker-dealers are individuals who are engaged in the business of effecting transactions in securities for themselves or others. COX ET AL., *supra* note 119, at 1020.

156. Unlike broker-dealers, funding platforms cannot offer investment advice or recommendations; solicit purchases, sales, or offers to buy the securities disclosed on its platform; compensate employees, agents, or other persons for such solicitation; or hold, manage, or possess investor funds or securities. *Registration of Funding Portals*, U.S. SEC. & EXCHANGE COMMISSION, [http://www.sec.gov/divisions/marketreg/tmcompliance/fpreigationguide.htm](http://www.sec.gov/divisions/marketreg/tmcompliance/fpreistrationguide.htm) [<http://perma.cc/7AUR-P92S>].

educational materials about crowdfunding, review information disclosed by the companies seeking investment, and participate in forums about the investment opportunities.¹⁵⁷ The exemption allows unaccredited investors to buy and sell shares through funding platforms with comparatively minimal restrictions – a cap on how much they can invest on such platforms each year and a holding period of one year, during which shares can be sold to accredited investors, family members, or back to the issuer.

Regulation A+ is another regulatory reform that opens the possibility of art exchanges. The principal benefits of this exemption are higher fundraising caps, the ability to engage in general solicitation (the ability to advertise the offering to the general public), and minimal resale restrictions. The additional disclosure and reporting requirements would make this exemption less attractive than Regulation Crowdfunding for nascent art companies but could be useful for larger, more established ones who are seeking to raise larger sums of funding and are less deterred by the costs of the additional requirements. Regulation A+ also does not require transactions to occur through a broker-dealer or funding platform. However, given that an important aspect of art exchanges is that they have an intermediary facilitating the buying and selling of shares, the lack of this requirement in Regulation A+ is not very significant – an art exchange would involve some form of an intermediary platform regardless of whether the exemption required one.

Although these exemptions were designed to help startups raise funds from small investors, they can be adapted to facilitate the creation of art exchanges. Instead of crowdfunding platforms with traditional startups, art exchanges would be funding platforms that host art management companies that buy, manage, and sell artworks. These art management companies could be highly specialized or diversified, providing investors with a variety of investment opportunities.

Although past art exchanges have usually focused on allowing investors to buy shares in single artworks, the model proposed here would work even better if the art management companies invested in a collection of artworks. It would be more efficient for each art company to manage multiple artworks and spread the costs of personnel across the pieces. Having investors invest in companies with collections of artwork would also make it easier for less savvy investors to diversify their portfolios. Furthermore, investing in collections rather than individual pieces would make rampant speculation, which plagued Chinese art exchanges, less likely: unwarranted excitement over one artwork or artist would be

157. *Updated Investor Bulletin: Crowdfunding for Investors*, U.S. SEC. & EXCHANGE COMMISSION (May 20, 2017), http://www.sec.gov/oiea/investor-alerts-bulletins/ib_crowdfunding-.html [<http://perma.cc/L8HN-L5RA>].

less likely to lead to excessive demand for the company's shares when that artwork or artist is only a small part of the company's entire holdings.

Compared to art funds, the main downside of the art exchange model is that investors would not be able to benefit from the economies of scope and scale of investing in an art fund. Art funds have external management structures, meaning that their management resides in an external entity, a firm that owns many funds. External management structures allow for more efficient allocation of human capital and resources since all of the funds are able to share such resources. Moreover, investors in art management companies, in contrast to art funds, would be exposed not only to the risks inherent in the artworks themselves but also in the risks associated with the quality of the company's management. Since the managers and operational assets (e.g., computers and equipment) of art funds are owned by a separate management company, the value of an art fund is limited to the value of the investment assets, whereas the value of an art management company would include the value of the managers and operational assets.¹⁵⁸

Nonetheless, the gains of the art exchange model likely outweigh its downsides. For example, investors could have greater control over the art management company through voting rights. Furthermore, the centralized system of having many art companies listed on a single funding platform would also facilitate the creation of a robust art rental market, as the funding platform could also act as a repository for art rental options. The liquidity and accessibility that the art exchange model provides likely would outweigh efficiency concerns for many investors, particularly unaccredited investors who currently have little access to art funds, and who would also especially value the ability to sell their shares.

Thus, recent regulatory reforms make the creation of art exchanges easier and less costly. As will be discussed further in the following two sections, Regulation Crowdfunding would be more appropriate for smaller art companies, whereas Regulation A+ would be more beneficial for larger art companies. These regulations create new opportunities for unaccredited investors to invest in private companies and reduce the restrictions on their ability to sell their shares, thus enabling two of the core features of art exchanges to be manifested in new investment offerings.

¹⁵⁸. See Morley, *supra* note 23, at 1258-59.

1. Regulation Crowdfunding

Regulation Crowdfunding¹⁵⁹ allows companies to raise up to \$1,070,000 a year¹⁶⁰ from investors through peer-to-peer funding platforms. Given how expensive art can be, this exemption would be most useful for small art companies or art companies that have a steady revenue source – e.g., art rental – so that they only need modest yearly funding infusions.

Like Regulation D – the exemption art funds rely on – investors are able to resell their shares without restrictions after a one-year holding period. Unlike Regulation D, however, within that year, investors can sell their shares without registration to an accredited investor, the issuer of the securities, or a family member, making these shares significantly more liquid than shares in art funds.¹⁶¹

In addition, unlike Regulation D, which caps the number of unaccredited investors in the fund at thirty-five, there are no restrictions under Regulation Crowdfunding on how many unaccredited investors would be able to invest in these art investment vehicles. Instead of restricting the number of unaccredited investors who can invest, Regulation Crowdfunding restricts how much each unaccredited investor can invest in a given year. Investors whose net worth or annual income are both less than \$107,000 cannot invest more than \$2,200, or 5% of the lesser of the investor's annual income or net worth.¹⁶² Investors with over \$107,000 in both net worth and annual income can invest up to 10% of the lesser of their net worth or annual income.¹⁶³

The investor caps, though potentially restrictive, might actually be advantageous in protecting unsophisticated investors and preventing rampant speculation that could undermine the stability of nascent art exchanges. Given that predicting returns and risk from art investments is difficult, and that many small investors might lack experience in evaluating art companies, allowing them to invest up to 5% or 10% of their income would provide these investors with the benefits of diversifying their portfolios without exposing them to excessive risk. Moreover, the holding-period requirement would further mitigate the risk of excessive speculation by maintaining some barriers to flipping shares.

Another prominent feature of Regulation Crowdfunding is that the buying and selling of shares must be conducted through a funding platform or a broker-

^{159.} 17 C.F.R. § 227 (2017).

^{160.} *Id.* § 227.100(a)(1).

^{161.} *Id.* § 227.501.

^{162.} *Id.* § 227.100(a)(2)(i).

^{163.} *Id.* § 227.100(a)(2)(ii).

dealer registered with the SEC. This requirement is designed to protect investors; the funding platform is charged with obtaining background information from the company, making that information available to investors, and securing investors' affirmations that they understand the risks of loss and illiquidity.¹⁶⁴ In particular, companies are required to provide general information about the company, its officers and directors, a description of the business, the planned use for the money raised from the offering, the target offering amount, the deadline for the offering, related-party transactions, risks specific to the company, and financial information, among other information.¹⁶⁵ The level of financial disclosure required depends on the amount of money the company is raising. Companies raising more than \$100,000 must have their financial statements reviewed by an independent public accountant, and companies raising more than \$500,000 must be audited by an independent public accountant if it is not the company's first time crowdfunding.¹⁶⁶

Notably, however, Regulation Crowdfunding exempts offerings from blue sky registration requirements,¹⁶⁷ a significant benefit given that one of the major reasons funds and companies have sought to limit their offerings to accredited investors has been to take advantage of the preemption of blue sky registration requirements provided by Rule 506 of Regulation D.¹⁶⁸ Blue sky laws are state securities laws that require issuers to comply with additional disclosure and sometimes merit-based requirements, adding to the costs associated with making a securities offering.¹⁶⁹

The costs associated with making disclosures and with the creation of a funding platform have garnered criticism, however, from commentators who predict that these costs combined with the low ceiling for fundraising under Regulation Crowdfunding will render the exemption too expensive to be worthwhile for most small companies.¹⁷⁰ Nonetheless, Regulation Crowdfunding is groundbreaking in that it specifically targets smaller investors that have been excluded

164. COX ET AL., *supra* note 119, at 312.

165. 17 C.F.R. § 227.201(a)-(y).

166. *Id.* § 227.201(t).

167. *Crowdfunding Offerings Under Section 4(a)(6)*, PRAC. L. CORP. & SEC., <http://us.practicallaw.thomsonreuters.com/8-547-3405> [<http://perma.cc/6F5P-Y6RK>].

168. COX ET AL., *supra* note 119, at 279 (describing how an advantage of Rule 506 is that securities issued under the exemption are not subject to state regulation through registration).

169. *Id.* at 19. In states with merit-based review requirements, the state has the authority to prevent a securities offering if it deems that it is unfair or presents excessive risk to investors. *Id.*

170. See, e.g., *id.* at 313; Joan MacLeod Heminway, *How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions, and Inexpert Judgments that Begs for a Happy Ending*, 102 KY. L.J. 865, 867 (2014).

from the private company market. Moreover, to the extent that the costs do turn out to be prohibitive, it is possible that the SEC might amend the caps to make the exemption more attractive, as it has done in the past with other exemptions.¹⁷¹ Thus, Regulation Crowdfunding has created a promising new exemption from securities registration requirements that could enable small investors to participate in the art market by investing in art management companies on art exchanges.

2. Regulation A+

Instead of Regulation Crowdfunding, art companies that want to raise higher sums of money from investors could use the exemption under Regulation A+.¹⁷² Regulation A+ has more reporting requirements, but also has greater flexibility and much higher annual fundraising caps. Regulation A+ has two tiers. Tier 1 has an annual cap of \$20 million, while Tier 2 has an annual cap of \$50 million.¹⁷³ Neither tier restricts how many unaccredited investors can invest in the offering, but Tier 2 limits the amount of money an unaccredited investor can invest to 10% of the greater of the investor's annual income or net worth.¹⁷⁴ In terms of ongoing reporting requirements, Tier 2 requires issuers of stock to file semiannual reports, annual reports, special financial reports, and current reports.¹⁷⁵ Under Tier 1, issuers only have to file exit reports after the completion of an offering¹⁷⁶ but, unlike Tier 2, Tier 1 does not exempt the offering from state blue sky laws.¹⁷⁷ Under Regulation A+, the only restriction on resale that inves-

171. Regulation A+, in fact, was one such reform effort after the caps under Regulation A were deemed too low to be useful. Rapp, *supra* note 41.

172. 17 C.F.R. §§ 230.251-263 (2017). Regulation A+ builds upon the previously existing Regulation A. See COX ET AL., *supra* note 119, at 322.

173. 17 C.F.R. § 230.251(a)(1)-(2). Note that there are additional subcaps (\$6 million and \$15 million) for the amount of money that companies can raise from affiliates (people who have a relationship of control with the issuer, e.g., officers and directors of the company).

174. *Id.* § 230.251(d)(2)(C).

175. *Id.* § 230.257(b)(1)-(4).

176. *Id.* § 230.257(a).

177. See Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Rules To Facilitate Smaller Companies' Access to Capital, (Mar. 25, 2015), <http://www.sec.gov/news/pressrelease/2015-49.html> [<http://perma.cc/DS2C-B92K>] (“[T]he rules provide for the preemption of state securities law registration and qualification requirements for securities offered or sold to ‘qualified purchasers,’ defined to be any person to whom securities are offered or sold under a Tier 2 offering.”).

tors face is that investors selling their shares in the first year after the initial Regulation A+ offering must not constitute more than 30% of the aggregate offering.¹⁷⁸

In terms of solicitation, companies using Regulation A+ may “test the waters,” soliciting interest from the general public before or after the filing of an offering statement, provided that the solicitation materials are accompanied by a preliminary offering circular.¹⁷⁹ The ability to solicit the general public rather than just accredited investors is one of the major advantages of Regulation A+ over Regulation D.¹⁸⁰ Under Regulation D, unaccredited investors can generally only find out about the investment opportunities through interactions with individuals with whom they have a prior relationship.¹⁸¹ On top of the limitation on the number of unaccredited investors that can invest in a Regulation D offering,¹⁸² restrictions on solicitation make it difficult for unaccredited investors to even hear about such investment opportunities. Being able to solicit the general public under Regulation A+ would thus make it far easier for art exchanges to make their offerings known to a broader array of investors. Investors would not need to have connections to those running the art management companies in order to find out about potential investment opportunities.

Overall, the biggest trade-off between the two exemptions is that Regulation Crowdfunding involves fewer disclosure and reporting requirements, while

178. 17 C.F.R. § 230.251(a)(3). Note, however, that there are additional resale restrictions for affiliates. See *Regulation A+: Final Rules Offer Important Capital Raising Alternatives*, MORRISON FOERSTER 9 (Mar. 26, 2015), <http://media2.mofo.com/documents/150326regulationa.pdf> [<http://perma.cc/TL5J-ZY4E>].

179. *Regulation “A+” Offerings Under Amended Regulation A*, PRAC. L. CORP. & SEC., <http://us.practicallaw.thomsonreuters.com/6-553-7385> [<http://perma.cc/Z6TA-K8BQ>].

180. COX ET AL., *supra* note 119, at 321.

181. After the passage of the JOBS Act, companies and funds using Rule 506(c) of Regulation D can now engage in general solicitation. *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings: A Small Entity Compliance Guide*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/info/smallbus/secg/general-solicitation-small-entity-compliance-guide.htm> [<http://perma.cc/X9WK-SB2L>]. Rule 506(c) limits the offering to accredited investors, however. *Id.* Rule 506(b), which allows up to 35 unaccredited investors to participate, still bans general solicitation. *Id.* The main safe harbor from general solicitation is to offer the securities to “a prospective investor with whom the issuer, or a person acting on the issuer’s behalf, has a pre-existing, substantive relationship.” *Question 256.26, Securities Act Rules: Questions and Answers of General Applicability*, U.S. SEC. & EXCHANGE COMMISSION (Nov. 6, 2017), <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm> [<http://perma.cc/L34U-YU4E>].

182. Rule 506(b) of Regulation D allows up to thirty-five unaccredited investors to participate in the offering, whereas Rule 506(c) does not allow any unaccredited investors to participate. *Rule 506 of Regulation D*, *supra* note 121.

Regulation A+ allows much higher maximum offering amounts (\$25 or \$50 million versus \$1.07 million) and fewer restrictions on investors' ability to sell their shares. Both exemptions, however, greatly expand the potential investor base of art investment vehicles by allowing an unlimited number of unaccredited investors to invest in the offerings and allowing for far more liquid shares by greatly reducing resale restrictions. Thus, these regulatory reforms have paved the way for the creation of art exchanges by enabling their core features of greater accessibility and liquidity.

CONCLUSION

Past art investment vehicles have largely failed to have a significant impact on the art market. This Comment has isolated a few of the main challenges facing art investment vehicles: the illiquidity of the art market, misaligned incentives between art investment vehicles and primary market players, and regulatory constraints. Through developing a robust art rental market, creating mutually beneficial contractual arrangements with primary market players, and leveraging recent regulatory changes to create art exchanges, more investors will be able to participate in the art market, and those that do will have access to higher potential returns and more liquid investment opportunities. Through these innovations, art investment vehicles can open up the art market to a much broader array of participants and help unlock the investment potential of high-end art.

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