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Notes and Comments

SHOULD SIZE OR WEALTH EQUAL SOPHISTICATION IN FEDERAL SECURITIES LAWS?

Greg Oguss

ABSTRACT—In the wake of the financial crisis of 2008, there has been substantial debate about the wisdom of offering exemptions from federal securities laws for investment products sold solely to wealthy institutions and individuals, such as the accredited investor provisions of Regulation D of the Securities Act of 1933. Following an examination of case studies dealing with the derivatives craze of the mid-1990s and the aftermath of the 2008 housing market meltdown, this Comment concludes that the now-antiquated wealth-based benchmarks in such exemptions have resulted in the chronic underprotection of larger public and private investors. Accordingly, this Comment argues that several revisions to the existing benchmarks and related regulations should be considered. First, the numerical benchmarks in such exemptions should be inflation-adjusted and inflation-indexed from now on. Second, a series of graduated caps on the purchase of exempt investment products as a percentage of net worth should be introduced. Finally, the standard of care imposed on broker-dealers who market and sell investment products to accredited and unaccredited investors alike should be raised to the equivalent of the fiduciary duty imposed on registered investment advisers.

AUTHOR—J.D. Candidate, Northwestern University School of Law, 2013. Many thanks to Professors David Ruder and Allan Horwich for their assistance and to my fellow students Yosef Schwartz, Mary Novak, and Jeff VanDam for their feedback.

INTRODUCTION

The federal securities laws in the United States frequently rely on the notion that institution size and personal wealth are useful proxies for investor sophistication. A multitude of exemptions for wealthy individuals and large institutions in the Securities Act of 1933 (1933 Act) leave such groups less protected by the mandated-disclosure regime of federal regulation than the average investor.[1] Based on these exemptions, issuers

[1] Many of these mandatory disclosures apply only to registered offerings, leaving investors who purchase exempt securities less protected. In contrast to the federal disclosure-based regime, many state

and underwriters can sell securities to certain wealthy investors without enduring the legal and accounting costs of preparing a registration statement, opting instead to use a less costly private placement memorandum as a marketing document.

In light of such exemptions, it is interesting to note, as litigator Lawrence Melton has, that the original text of the 1933 Act and the Securities Exchange Act of 1934 (1934 Act) are both "*silent* on the issue of investor sophistication."[2] Melton argues that a lack of distinctions for the protections afforded to investors large and small "is in keeping with the fundamental precept of American jurisprudence," which endeavors to treat all individuals identically, whether they are "giants" or "pygmies."[3]

The statutory use of sophistication proxies may stem from a desire to codify the 1953 Supreme Court decision in *SEC v. Ralston Purina Co.*[4] In this influential opinion, the Court held that the § 4(2) exemption of the 1933 Act—which does not mention sophistication—was intended to apply to purchasers "able to fend for themselves."[5] Building on *Ralston Purina*'s premise, the "sophisticated investor doctrine" extended the Court's reasoning to a variety of contexts,[6] including so-called suitability cases where investors pursue claims against broker-dealers for unsuitable investment recommendations.[7]

Several decades after *Ralston Purina*, lawmakers and Securities and Exchange Commission (SEC) regulators began to embrace exemptions that substituted numerical benchmarks based on personal wealth or institution size as bright-line standards for the difficult-to-quantify concept of investor sophistication.[8] A prime example is the Rule 215 and Regulation D definition of "accredited investor," which allows qualifying offerings sold

"blue sky laws" incorporate some merit-based regulation of securities offerings. *See* ALAN R. PALMITER, SECURITIES REGULATION: EXAMPLES AND EXPLANATIONS 43 (5th ed. 2011).

[2] Lawrence C. Melton, *Giants and Pygmies: The Fallacies of the Sophisticated Investor Doctrine*, PIABA B.J., Winter 2006, at 64, 64.

[3] *Id.* Melton's title references Justice Douglas's observation that "[t]he [1934] Act does not speak in terms of 'sophisticated' as opposed to 'unsophisticated' people dealing in securities. The rules when the giants play are the same as when the pygmies enter the market." Scherk v. Alberto-Culver Co., 417 U.S. 506, 526 (1974) (Douglas, J., dissenting).

[4] 346 U.S. 119 (1953).

[5] *Id.* at 125.

[6] *See infra* Part II.B.

[7] If a defendant can persuade a court or arbitrator that a plaintiff has sufficient knowledge and experience to evaluate the risks of investing, a suitability claim is less likely to succeed. *See* Edward Pekarek & Christian Obremski, *Is the Sophisticated Investor Theory Still Relevant?*, SEC. LITIG. & ARB. (Feb. 2, 2011, 6:28 PM), http://nysbar.com/blogs/SecuritiesLitigation/2011/02/is_the_sophisticated_investor.html.

[8] As an American Bar Association committee has pointed out, sophistication "is a shorthand way of expressing a rather complex thought." Fed. Regulation of Sec. Comm., Am. Bar Ass'n, *Section 4(2) and Statutory Law*, 31 BUS. LAW. 485, 493 (1975).

only to such investors substantial relief from the rigors and costs of 1933 Act registration.[9]

Another area where sophistication proxies based on wealth and income appear is in the aforementioned sophisticated investor defense often deployed by broker-dealers in suitability cases.[10] Despite its questionable legal sufficiency,[11] defendants continue to deploy the defense because it is persuasive to arbitration panels.[12] It is difficult to divorce discussion of the treatment of sophistication in statutory benchmarks from discussion of the treatment of sophistication in suitability cases. Accordingly, this Comment examines investor sophistication in each of these contexts.

I am not the first to note contradictions in the sophistication proxies employed by federal securities laws. In 1988, six years after the SEC's promulgation of Regulation D established sophistication proxies in the 1933 Act,[13] Professor C. Edward Fletcher wondered skeptically:

> [S]hould the law presume that wealthy investors, who can bear investment risks, are sophisticated investors, and treat them as such, no matter how financially naive they may be? Conversely, should the law treat poor, but financially sophisticated investors, who cannot bear investment risks, like other sophisticated investors? In short, what role should wealth and sophistication play in the determination whether an issuer must undertake 1933 Act registration?[14]

Commenting on the financial crisis of 2008, a *Forbes* columnist phrased this worry more boldly, mocking "a legal system that . . . says people who have or control a lot of money are automatically smarter than the little guy

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[9] *See infra* Part I.A. On April 5, 2012, President Obama signed the Jumpstart Our Business Startups (JOBS) Act, which, although it did not alter the accredited investor standards, substantially relaxed the restrictions on general solicitations of investors in qualifying smaller offerings in the interest of making it easier for smaller companies to raise capital. *See* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

[10] *See infra* Part II.B.

[11] As Melton notes, "Even though there is no legal basis for the defense, arbitrators seem to be swayed [by] it." Melton, *supra* note 2, at 64. Similarly, attorney James J. Eccleston argues, "[I]n the context of a simple negligence action for recommending an unsuitable investment, the sophistication defense is not legitimate." James J. Eccleston, *The "Sophisticated" Investor Defense to Suitability Claims; More Frequently Raised than Proven*, FINANCIALCOUNSEL.COM INVESTOR (2003), http://investor.financialcounsel.com/Articles/Investment/ARTINV0000236-SophisticatedInvestor.pdf.

[12] *See* Melton, *supra* note 2, at 64; Pekarek & Obremski, *supra* note 7.

[13] Prior to the enactment of Regulation D, Rule 146, adopted in 1974, offered a safe harbor for private offerings that required: (1) all offerees be sophisticated or wealthy and (2) actual purchasers be sophisticated or consult a financial advisor. The path from Rule 146 to Regulation D can be described as a move from a conjunctive test where wealth and sophistication were both necessary for an exemption to a disjunctive test where one or the other will suffice. *See* C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1123 ("This entire scheme changed in 1982, when the SEC promulgated Regulation D . . . . The new Rule replaces the old Rule's dual requirement of access *and* sophistication with a dual requirement of access and *either* sophistication *or* wealth.").

[14] *Id.* at 1123–24.

and therefore don't need as much protection. The last year proves this assumption false."[15]

Today, the debate continues. A January 2012 *New York Times* article phrased the problem as "Deciding Who's Rich (or Smart) Enough for High-Risk Investments."[16] On the occasion of the SEC's announcement of a minor revision to Regulation D, the article quoted a Sullivan & Cromwell partner acknowledging that "[i]t's an interesting question as to why [wealth] qualifies someone as sophisticated."[17] The article opined that "using money as a stand-in for financial sophistication is a fairly unsophisticated solution" and offered several alternative proposals that could make for more efficient approaches.[18]

The debate has been energized by recent revelations of large public entities—treated as sophisticated by securities laws—losing staggering sums on very high-risk investments during the recent financial crisis. Two of the saddest stories concern a $200 million loss on collateralized debt obligations (CDOs) suffered by five cash-strapped Wisconsin school districts and a $650 million loss on interest-rate swaps by the recently bankrupted Jefferson County, Alabama.[19]

Criticisms of wealth- and size-based sophistication proxies often lead commentators to three arguably contradictory arguments: (1) federal securities laws are overprotective of small investors and should be relaxed because they unfairly bar less wealthy investors from potentially lucrative opportunities,[20] (2) federal securities laws are underprotective of large investors and should be strengthened,[21] and (3) federal securities laws are

15 John E. Girouard, *The Sophisticated Investor Farce*, FORBES.COM (Mar. 24, 2009, 12:30 PM), http://www.forbes.com/2009/03/24/accredited-investor-sec-personal-finance-financial-advisor-network-net-worth.html; *see also* Wulf A. Kaal, *Hedge Fund Regulation via Basel III*, 44 VAND. J. TRANSNAT'L L. 389, 436 (2011) ("[T]he general policy of qualifying investors by using wealth as a proxy for sophistication seems questionable.").

16 Paul Sullivan, *Deciding Who's Rich (or Smart) Enough for High-Risk Investments*, N.Y. TIMES, Jan. 14, 2012, at B5.

17 *Id.*

18 *Id.*; *see infra* Part IV.A; *infra* note 182.

19 *See infra* Part III.C.

20 *See, e.g.*, Houman B. Shadab, *Fending For Themselves: Creating a U.S. Hedge Fund Market for Retail Investors*, 11 N.Y.U. J. LEGIS. & PUB. POL'Y 251, 319 (2008) (arguing that allowing retail investors easier access to less-regulated hedge fund investments "will not increase the risks to which they are already exposed" and "will . . . help [them] fend for themselves").

21 *See, e.g.*, Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291, 317 (1994) ("Few garner less sympathy in the ongoing public policy debate than do the wealthy. The obligation of the law, however, to do justice to the rich as well as to the poor suggests that sacrificing the accredited investor on the altar of small business capital formation is difficult to justify . . . .").

both overprotective of small investors and underprotective of large investors and should be adjusted accordingly.[22]

In addition to the criticisms that wealth and size inaccurately reflect actual sophistication, another reason to consider modifying the exemptions based on these factors is the ever-expanding number of complex investment products confronting investors. Nonetheless, legislators and regulators seemingly continue to adhere to the philosophy that if wealthy individuals and institutions have not proven more sophisticated, they can at least afford to hire intelligent advisors and are better able to tolerate investment losses. Regrettably, the latest SEC modification of Rule 215 and Regulation D[23] and a recent SEC staff study each reflect a continued adherence to the belief that the current benchmarks for investor wealth and size are adequate proxies for sophistication.[24]

This Comment illustrates the dangers of continuing along this path without substantive modifications by offering a two-pronged argument: (1) wealth and size have at times proven poor proxies for investor sophistication and (2) given that large numbers of investment products are proving increasingly complex and hard to value, investor sophistication no longer affords the degree of protection it once did.[25] Part I of this Comment

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[22] *See, e.g.*, Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733, 754 (2009) ("[T]his bright-line standard is both under- and overinclusive.").

[23] *See infra* Part I.B.

[24] The SEC staff study proposed "establishing a uniform fiduciary standard for investment advisers and broker-dealers when providing investment advice about securities to retail customers . . . consistent with the standard that currently applies to investment advisers." SEC STAFF, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS ii (2011) [hereinafter SECTION 913 STUDY], *available at* http://www.sec.gov/news/studies/2011/913studyfinal.pdf. In focusing on "retail customers," the study declined to recommend applying the standard to a broker-dealer's interactions with institutional investors. Notably, the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act) provides the SEC with the power to expand investment adviser standards to broker-dealers for all customers, not just retail investors. § 913(f), Pub. L. No. 111-203, 124 Stat. 1376, 1827 (2010).

[25] As Professor Helen Parry notes:

> [I]n recent years . . . [investors] are being tempted to venture into those sectors which carry more risk and leverage . . . . Such markets have proved to be very strange, volatile and frightening places even for relatively experienced investors, such as those who work for the treasury departments of major corporations or public sector agencies.

Helen Parry, *Hedge Funds, Hot Markets and the High Net Worth Investor: A Case for Greater Protection?*, 21 NW. J. INT'L L. & BUS. 703, 719 (2001); *see also* Wulf A. Kaal, *Hedge Fund Valuation: Retailization, Regulation, and Investor Suitabilty*, 28 REV. BANKING & FIN. L. 581, 590–91 (2009) ("[T]he constant invention and production of new instruments and structures often make [investments] difficult to price. . . . Many of these hard-to-value assets, including collateralized debt obligations . . . and collateralized loan obligations . . . are so complex that accurate valuation may never be achieved . . . ."); *Seller's Remorse? Wall Street Rethinking Suitability of 'Suitability,'* INVESTMENTNEWS (June 3, 2010, 7:45 AM), http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20100603/FREE/100609969 [hereinafter *Seller's Remorse?*] ("While the definition of sophisticated hasn't changed in decades, Wall Street has been selling increasingly complex products, such as swaps, auction-rate securities and collateralized debt obligations . . . .").

maps some of the areas of federal securities laws that rely on wealth- and size-based sophistication proxies. Part II examines the use of sophistication proxies in suitability cases and other litigation contexts. Part III offers three case studies of massive losses suffered by private and public institutional investors that illustrate the flawed assumptions of the current approach. Part IV offers a pair of proposals for modifying securities laws and regulations in an effort to beef up the protection of institutional investors. The first proposal encompasses an inflation- and diversification-sensitive approach to the numerical statutory benchmarks that represent sophistication, such as the Regulation D accredited investor standards. The second proposal concerns the treatment of investor sophistication by courts and arbitration panels, recommending a heightening of the standard of care[26] imposed on broker-dealers equivalent to the fiduciary duty imposed on registered investment advisers (RIAs) under the Investment Advisers Act of 1940 (Advisers Act).[27]

I. WEALTH AND SIZE AS SOPHISTICATION IN STATUTORY EXEMPTIONS FROM FEDERAL SECURITIES LAWS

The protection of credulous investors was the motivation behind the first federal securities laws passed in response to the abuses in financial markets of the 1920s that culminated in the crash of 1929.[28] In some tension with this motivation, in recent decades, commentators have increasingly emphasized the goal of enabling companies to access capital efficiently in investment markets as the foundation of securities laws.[29] Proponents of the capital formation rationale see fewer regulatory controls as a means of achieving this goal.[30] While the emphasis on disclosure-based investor protection still forms the core regulatory principle, the influence of the capital formation rationale, a belief in market efficiency, and fears about

26 Suitability rules define the standard of care for broker-dealers making investment recommendations to their customers. *See infra* Part II.B.

27 15 U.S.C. §§ 80b-1 to -21 (2006); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963) (noting the Advisers Act codified the common law to prevent “fraudulent securities transactions by fiduciaries”).

28 As Fletcher points out, the “legislative history [of the 1933 and 1934 Acts] shows that nearly every provision was motivated . . . by concerns with predation on individual investors.” Fletcher, *supra* note 13, at 1134.

29 Beginning in the late 1970s, investor protection was redefined as “regulators strove to insure the economic efficiency of securities markets,” which entailed the “embrace” of the “goal of encouraging capital formation.” Friedman, *supra* note 21, at 291, 301; *see also* Roberta S. Karmel, *Regulation by Exemption: The Changing Definition of an Accredited Investor*, 39 RUTGERS L.J. 681, 681 n.1 (2008) (noting the genesis of Regulation D was concerns about small businesses’ access to capital).

30 In 1978, the SEC held hearings to consider how the 1933 and 1934 Acts contributed to the problems faced by small companies seeking capital. The initial result was the adoption of Rule 242, a forerunner to Rule 505, permitting certain issuers to sell up to $2 million worth of “securities to an unlimited number of accredited investors plus 35 other” individuals. *See* Friedman, *supra* note 21, at 303–04.

tight credit markets have increasingly pushed regulators to offer exemptions to the costs and burdens of disclosure.[31]

Many exemptions turn on the personal wealth or institutional size of potential investors. A prime example is the introduction of Regulation D in 1982. In response to concerns about the ability of businesses to access credit markets cheaply and efficiently, Regulation D exempted from 1933 Act registration requirements certain qualified offerings to accredited investors with a net worth of $1 million or more.[32] The remainder of Part I maps the current wealth- and size-based exemptions from securities laws, starting with Regulation D. Part II examines the use of similar sophistication proxies in suitability claims brought by disgruntled customers against broker-dealers.

A. The Treatment of Wealth and Size as Sophistication in Regulation D and Rule 215

As is the case with many areas of securities law, the state of play with respect to the statutory treatment of wealth, size, and sophistication is complex and resists easy summarization. The accredited investor definition in Regulation D and Rule 215 of the 1933 Act is the place commentators typically begin the discussion. One of many exemptions for wealthy investors in federal securities laws, Regulation D represents a nonexclusive, bright-line safe harbor for the § 4(2) exemption from the 1933 Act's registration and prospectus delivery requirements for "transactions by an issuer not involving any public offering."[33]

Regulation D is responsible for much of the private placement market where large institutions and wealthy individuals make investments in financial products offered by issuers and underwriters who are not subject to the costs of registration or its mandatory disclosure requirements.[34] Additionally, Regulation D is the vehicle used by many hedge funds and private equity funds to raise capital from investors.[35]

The accredited investor concept was first inserted into the 1933 Act by a 1980 amendment.[36] This legislation was motivated by "Congressional concern that small businesses should have an adequate market to raise capital and that investors should not be unnecessarily impeded from

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[31] *See id.* at 292–305.

[32] *See infra* Part I.A.

[33] 15 U.S.C § 77d(2) (2006).

[34] *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 281–87 (6th ed. 2009).

[35] On hedge funds' reliance on Regulation D, see *id.* at 286. On private equity funds' reliance on Regulation D, see JACK S. LEVIN, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS ¶¶ 207.1–.3.8 (2011).

[36] *See* Karmel, *supra* note 29, at 681.

purchasing securities of small businesses."[37] In 1982, the SEC defined and deployed the term "accredited investor" in Rule 215 and Rule 501 of Regulation D.[38] The definition includes enumerated large institutional investors such as financial institutions, pension funds, and corporations with assets exceeding $5 million.[39] It also includes individuals or married couples whose net worth "at the time of the sale" exceeds $1 million or whose annual income in each of the past two years exceeds: (a) $200,000 for individuals and (b) $300,000 for couples, coupled with a reasonable expectation of reaching the same income level in the current year.[40]

Addressing concerns that the now-thirty-year-old numerical benchmarks in Regulation D are woefully behind the times, the Dodd–Frank Act directed the SEC to amend the accredited investor definition for individuals and married couples to subtract the value of a principal residence from the net worth calculation.[41] SEC Release No. 33-9287 stipulated that the Commission will do just that, amending the language of Rule 215 and Rule 501 to subtract any positive equity in a primary residence from the investor's net worth, while also excluding any negative equity within certain limits.[42]

The implications of amending Rules 215 and 501 for issuances directed at investors who meet the accredited investor standard are somewhat complex. If an issuance involves offers or sales solely to accredited investors, provided the aggregate offering price does not exceed $5 million and certain other requirements are met, § 4(5) of the 1933 Act exempts these offerings from registration.[43] For offerings pursuant to the Regulation D safe harbors of Rule 505 or Rule 506, an issuer need not comply with the information delivery requirements of Rule 502 if sales are solely to accredited investors and such sales do not count toward the thirty-five-purchaser limit imposed on issuances under these safe harbors.[44]

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[37] S. REP. NO. 96-958, at 45 (1980).

[38] The term is defined virtually identically in Rule 215 and in Rule 501(a) of Regulation D. 17 C.F.R. §§ 230.215, 230.501(a) (2011).

[39] *Id.* § 230.501(a).

[40] *Id.*

[41] Dodd–Frank Act § 413(a), Pub. L. No. 111-203, 124 Stat. 1376, 1577 (2010).

[42] Net Worth Standard for Accredited Investors, Securities Act Release No. 33-9287, Investment Company Act Release No. 29,891, 76 Fed. Reg. 81,793, 81,794 (Dec. 29, 2011). To prevent manipulation of the standard, indebtedness secured by a primary residence will be treated as a liability if "the borrowing occurs in the 60 days preceding the purchase of securities in the exempt offering and is not in connection with the acquisition of the primary residence." Press Release, SEC, SEC Adopts Net Worth Standard for Accredited Investors Under Dodd–Frank Act (Dec. 21, 2011), *available at* http://www.sec.gov/news/press/2011/2011-274.htm.

[43] 15 U.S.C.A. § 77d(a)(5) (2012).

[44] 17 C.F.R. §§ 230.505(b)(2)(ii), 230.506(b)(2)(i). While Rule 505 offerings have a cap of $5 million, Rule 506 offerings are unlimited. *Id.* § 230.505(b)(2)(i).

Importantly, selling an offering only to accredited investors also overrides the less bright-line investor sophistication requirement that Rule 506 imposes on issuances sold to unaccredited investors. The Rule requires that each purchaser who is not an accredited investor must, alone or with a purchaser representative, have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment."[45] While this use of a wealth-as-sophistication proxy undermines certain protections for wealthy investors in Rule 506 offerings, accredited investors have the right to request the information that must be provided to unaccredited investors in Regulation D offerings.[46]

The thinking here is twofold: (1) wealthy investors have a greater ability to "bear the economic risk" of investments,[47] and (2) wealthy investors have a greater ability to "purchase" sophistication by hiring financial advisors. Further, the provision of Regulation D noting accredited investors have a right to request information mandatorily provided to unaccredited investors suggests confidence that wealthier investors are also protected by the greater bargaining power they wield with issuers and sellers.

While there is merit to these arguments, it is hard to imagine the SEC believes the 1982 benchmarks of $1 million net worth for individuals and $5 million for institutions carry the same ability to purchase financial advice or wield bargaining power some thirty years later in 2012. Adjusting for inflation, $1 million in 1982 dollars has approximately the same buying power as $2.37 million does in 2012 dollars.[48] For $5 million in 1982 dollars, the equivalent amount in 2012 dollars is $11.87 million.[49] Just to keep pace with inflation, the income benchmarks for individuals and couples would have to be increased from $200,000 to $474,827 and from $300,000 to $712,240, respectively.

While it may be intuitively appealing, the idea that wealthy investors have a greater ability to bear economic risks associated with investing does not hold true if accredited investors are not prevented from investing their entire net worth in a transaction.[50] An individual with $70 million in net worth or a company with $700 million in net assets can no more afford to lose all of their capital in a financial investment than can an individual with a $7000 net worth. Worries of this type could explain some of the

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[45] *Id.* § 230.506(b)(2)(ii).

[46] *Id.* § 230.502(b)(2)(v).

[47] Net Worth Standard for Accredited Investors, 76 Fed. Reg. at 81,794.

[48] *See CPI Inflation Calculator*, BUREAU OF LAB. STAT., http://www.bls.gov/data/inflation_calculator.htm (last visited Nov. 10, 2012) [hereinafter *Inflation Calculator*].

[49] *Id.*

[50] A "100% of net worth investment" is always a possibility with respect to an uncapped Rule 506 offering and could conceivably be possible with a Rule 505 offering if an accredited investor's net worth is $5 million or less.

tremendous variation in the numerical benchmarks chosen to serve as sophistication proxies in securities and commodities laws over the last thirty years and the upward trend that the benchmarks have exhibited. Just as plausibly, worries about the erosional effects of inflation could be behind this upward trend, although inflation-pegged benchmarks would clearly be a more efficient way of handling such concerns. A brief survey of these ensuing exemptions follows.

B. The Treatment of Wealth and Size as Sophistication in Rule 144A

Adopted in 1990, the stated goal of Rule 144A is to achieve "a more liquid and efficient institutional resale market for unregistered securities."[51] Similar to the Regulation D provisions for accredited investors investing in primary offerings, Rule 144A deems the resales of securities[52] to "qualified institutional buyers" (QIBs) exempt from the registration and prospectus delivery requirements of the 1933 Act.[53] QIBs are defined to include (1) large institutional investors such as pension plans, financial institutions, and investment companies that own and invest on a discretionary basis at least $100 million in securities of issuers with whom they are not affiliated; (2) registered broker-dealers that own and invest at least $10 million of such securities; and (3) qualifying banks that own and invest at least $100 million of such securities and have a net worth of at least $25 million.[54]

While the 1990 QIB benchmarks have not been subject to quite the same level of inflationary erosion as the 1982 vintage Regulation D benchmarks, there has been a substantial impact here as well. The buying power equivalent of $100 million in 1990 dollars is approximately $175 million in 2012 dollars.[55] Twenty-five million dollars in 1990 dollars is equivalent to approximately $43.82 million in 2012 dollars.[56] As with the Regulation D benchmarks, the QIB benchmarks have never been adjusted for inflation, and there is no percentage cap on the amount of net worth that a QIB can invest in a Rule 144A offering. Although the use of Rule 144A was initially modest, by 2006 the amount of debt and equity raised under this exemption in sales to QIBs exceeded $1 trillion.[57]

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[51] Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Securities Act Release Nos. 33-6862, 34-27928, 55 Fed. Reg. 17,933, 17,934 (Apr. 30, 1990).

[52] Under securities laws, there are two primary types of transactions. A "sale" refers to an initial sale of securities by an issuer to raise capital from investors. A "resale" connotes a secondary transaction where a holder of securities sells into a trading market for liquidity purposes.

[53] 17 C.F.R. § 230.144A (2011).

[54] *Id.* § 230.144A(a)(1).

[55] *See Inflation Calculator*, *supra* note 48.

[56] *Id.*

[57] Karmel, *supra* note 29, at 689.

C. Wealth and Size as Sophistication in the Investment Company Act of 1940

Similar to the impetus behind the 1933 and 1934 Acts, the motivation behind the Investment Company Act of 1940 (1940 Act) was to increase the protection of credulous would-be investors by subjecting investment companies to additional SEC oversight.[58] The statute stipulates that mutual funds and other issuers engaged in the business of buying and selling securities must register with the SEC while also subjecting them to a variety of reporting, recordkeeping, and exam requirements as well as certain investment restrictions.[59] There are two principal statutory exemptions to the burden of registration, § 3(c)(1) and § 3(c)(7),[60] the latter of which employs wealth-based benchmarks as a sophistication proxy.

In response to worries that the § 3(c)(1) exemption for investment companies with 100 U.S. investors or less was overly restrictive, the SEC in 1992 proposed an exemption for companies that sold solely securities only to "qualified purchasers" considered sufficiently sophisticated based on wealth or size to not require statutory protection.[61] In 1997, the resulting § 3(c)(7) exemption went into effect, exempting investment companies with securities owned solely by qualified purchasers from disclosure and reporting requirements if they refrained from public offerings.[62] The definition of qualified purchasers includes (1) investors who own at least $5 million in investments and (2) institutions that own and invest at least $25 million[63] on a discretionary basis.[64]

As with Regulation D, Rule 215, and Rule 144A, the 1997 benchmarks for qualified purchasers under the 1940 Act have never been adjusted for inflation. In addition, the § 3(c)(7) exemption does not limit investments to some percentage of net worth less than 100%, undermining arguments that the exemption is warranted by wealthy investors' increased ability to bear economic risk. Although the inflationary erosion of the dollar values is less dramatic here because § 3(c)(7) was enacted in 1997, the $5 and $25

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58 *See* Evan M. Gilbert, *Unnecessary Reform: The Fallacies with and Alternative to SEC Regulation of Hedge Funds*, 2 J. BUS. ENTREPRENEURSHIP & L. 319, 326 (2009).

59 *See* Vijay Sekhon, *Can the Rich Fend for Themselves?: Inconsistent Treatment of Wealthy Investors Under the Private Fund Investment Advisers Registration Act of 2010*, 7 HASTINGS BUS. L.J. 1, 3 (2011).

60 15 U.S.C. § 80a-3(c)(1), (7) (2006).

61 *See* Parry, *supra* note 25, at 704.

62 § 80a-3(c)(7).

63 The wide variation in the dollar values chosen to connote investor sophistication in statutes and regulations suggests lawmakers and regulators have continually grappled with how to quantify this concept.

64 § 80a-2(a)(51). Qualified purchasers under the 1940 Act are also "qualified eligible persons" for purposes of the Commodity Exchange Act (CEA). 17 C.F.R. § 4.7(a)(2)(vi) (2011). Enacted in 2006, this regulation exempts commodity pools involving only qualified eligible participants from various registration, recordkeeping, and disclosure requirements imposed by the CEA. *Id.*

million benchmarks for qualified individuals and institutions would have to be increased to \$7.14 million and \$35.69 million respectively to equal the buying power of the 1997 benchmarks in 2012 dollars.[65]

II. JUDICIAL TREATMENT OF WEALTH AND SIZE AS SOPHISTICATION

A. Early Judicial Treatment of Wealth and Size as Sophistication

Prior to the promulgation of Regulation D as a safe harbor for nonpublic offerings, there was extensive treatment of investor sophistication in case law addressing whether an offering qualified for the private offering exemption of § 4(2) of the 1933 Act. The Supreme Court first addressed the issue in the 1953 *Ralston Purina* decision.[66] In this seminal opinion, the Court shifted the focus of the analysis from the total number of offerees to whether offerees were "able to fend for themselves."[67] An offering that meets this criteria is a transaction that does not "involv[e] any public offering."[68] While important harbingers of the regulatory trend, in the wake of the Regulation D safe harbor for private offerings, *Ralston Purina* and the associated line of cases has been rendered somewhat irrelevant.

Rendered similarly irrelevant by the Rule 144A safe harbor for resales, the case law on the relevance of sophistication in determining whether a company insider can resell an issuer's securities without registration evinces some interesting contradictions. In *Ackerberg v. Johnson*, the Eighth Circuit dismissed a plaintiff's 1933 Act claims on investor sophistication grounds where the plaintiff had a net worth in excess of \$1 million, an annual income of \$200,000, and a trading account with assets of \$500,000.[69] In contrast, a district court in the Ninth Circuit refused to grant a defendant's motion for summary judgment on investor sophistication grounds despite the fact that one investor was the founding director of a trust company and another had made equity investments of greater than \$50,000 and was the ex-CEO of a company being acquired in connection with the resale.[70]

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65 *See Inflation Calculator*, *supra* note 48.

66 SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

67 *Id.* at 125.

68 *Id.*

69 892 F.2d 1328, 1330, 1337 (8th Cir. 1989).

70 Hedden v. Marinelli, 796 F. Supp. 432, 437–38 (N.D. Cal. 1992) ("Defendants have introduced substantial evidence to support the conclusion that Plaintiffs are sophisticated investors . . . . Despite this evidence, . . . this court cannot conclude that these individuals were sufficiently sophisticated to not require the protections of the 1933 Act.").

Although largely moot, this contradictory case law suggests how difficult it is to quantify the concept of sophistication.[71] In discussing some of the inconsistencies, commentators have raised additional criticisms about the overreliance on investor sophistication in securities regulation. One such criticism points out that "even sophisticated investors may not be able to protect their own interests if they do not have the information they need or want about the issuer or cannot feasibly understand it."[72] Another critique notes the paradox of a "scheme requir[ing] registration of securities offered to *unsophisticated* investors," thereby ensuring that people who do not read prospectuses receive them, while not requiring they be provided to "*sophisticated* investors who would read and benefit from prospectuses if they received them."[73] Finally, an ABA committee and a noted treatise have each pointed out that courts tend to take a "polar approach[]" to investor sophistication,[74] labeling offerees as either sophisticated or unsophisticated when, in reality, "it [is] important to recognize that there are degrees of sophistication."[75]

B. The Treatment of Wealth and Size as Sophistication in Suitability Cases

Suitability cases are a still-relevant context where the issue of investor sophistication has been substantively addressed by courts and arbitration panels. A suitability case is essentially a negligence claim in which a customer alleges that a broker-dealer failed to disclose that a recommended financial product was "too risky to be suitable" for the plaintiff's account.[76] It is generally true that a sophisticated plaintiff will lose a suitability action against a broker.[77] In one such case, subsequently upheld by the Ninth

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[71] Similar contradictions exist in the *Ralston Purina* line of cases. For example, Fifth Circuit case law throughout the 1970s downplayed the importance of sophistication in the inquiry as to the public or private nature of an offering. *See, e.g.*, Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 901–03 (5th Cir. 1977) (concluding that "[s]ophistication is not a substitute for" the information disclosed in a registration statement because without access to such information, a sophisticated investor's sophistication is unhelpful); Hill York Corp. v. Am. Int'l Franchises, Inc., 448 F.2d 680, 690 (5th Cir. 1971) (rejecting the argument that sophistication of investors is dispositive). Conversely, in 1980, the Ninth Circuit labeled investor sophistication one of four factors in a multifactor test to determine whether an offering is public or private. SEC v. Murphy, 626 F.2d 633, 644–45 (9th Cir. 1980). In 1985, the Tenth Circuit indicated offeree sophistication is a relevant but nonessential condition for a private offering. Cowles v. Dow Keith Oil & Gas, Inc., 752 F.2d 508, 512 (10th Cir. 1985).

[72] Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 992.

[73] Fletcher, *supra* note 13, at 1125–26.

[74] COX ET AL., *supra* note 34, at 277.

[75] Federal Regulation of Securities Comm., *supra* note 8, at 492.

[76] COX ET AL., *supra* note 34, at 278.

[77] *See* Lyle Roberts, *Suitability Claims Under Rule 10b-5: Are Public Entities Sophisticated Enough to Use Derivatives?*, 63 U. CHI. L. REV. 801, 803 (1996) ("Although courts have been reluctant to recognize suitability claims brought by sophisticated investors, the complex nature of derivatives has prompted calls for expanding the suitability doctrine to protect institutional investors who do not

Circuit, a plaintiff was found to be sophisticated in light of his bachelor's degree in economics, his ability to understand financial reports, and his regular reading of investment advisory literature.[78] In a contrasting case that may function as an implicit critique of an overreliance on statutory wealth-as-sophistication proxies, an ex-housekeeper who inherited $500,000 in assets from a former employer she married was found to be unsophisticated.[79]

There are two problems regarding the use of the investor sophistication defense in the suitability cases. First, as many practitioners have noted, the sophisticated investor defense is essentially a means of eviscerating the suitability rules promulgated by self-regulatory organizations (SROs) and replacing them with the largely discredited laissez-faire doctrine of *caveat emptor*.[80] Second, courts in such cases "apparently see no relationship between these cases and other . . . cases involving sophisticated investors," nor do they "articulate any coherent theory to justify such different treatment of sophisticated and unsophisticated customers."[81]

The success of the investor sophistication defense in suitability cases and arbitrations[82] may have the perverse effect of making it more likely investors with small losses will prevail in disputes than investors with large losses deemed sophisticated enough to require less protection. This appears somewhat counterintuitive given that the temptation may be greater for brokers to recommend unsuitable investments to large customers given the fee-driven business model where brokers realize greater revenues on larger orders.[83]

C. Implications for Large Investors

Although suitability cases typically end up in arbitration,[84] judicial decisions in an analogous context suggest something of the difficulty large institutions face in recovering on claims involving complex financial

understand the risks of their investments." (footnote omitted)); *see also* Fletcher, *supra* note 13, at 1108 ("In cases involving sophisticated customers, courts are more likely to hold that no fiduciary relationship exists at all or that a broker's fiduciary duty is easily met." (footnote omitted)).

[78] Follansbee v. Davis, Skaggs & Co., 681 F.2d 673, 677, 678 (9th Cir. 1982).

[79] Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 423, 433 (N.D. Cal. 1968), *aff'd*, 430 F.2d 1202 (9th Cir. 1970).

[80] *See* Melton, *supra* note 2, at 67.

[81] Fletcher, *supra* note 13, at 1109.

[82] *See* Pekarek & Obremski, *supra* note 7 ("[T]he sophisticated investor defense is frequently used against various securities arbitration claims . . . .").

[83] As attorney-banker James White explains, "The risks of [the] 'latest new things' are compounded by a compensation system that pays people for innovation before the innovation is proven and without providing for individual penalties if it does not." James H. White, III, *Financing Plans for the Jefferson County Sewer System: Issues and Mistakes*, 40 CUMB. L. REV. 717, 743 (2010).

[84] *See* Eccleston, *supra* note 11 (noting that, in general, "securities arbitration [is] where investors seek to recover their investment losses").

products. In 2010, J.P. Morgan Chase was granted summary judgment and awarded fees in a breach of contract claim by Controladora Comercial Mexicana (CCM), Mexico's largest retail conglomerate, stemming from the conglomerate's nearly $500 million loss on interest-rate and foreign-exchange derivatives, two notoriously complex investments.[85] Also in 2010, a district court in the Second Circuit dismissed fraud, negligence, and breach of fiduciary duty claims by the San Diego County Employees Retirement Association (SDCERA), a pension fund, against Amaranth, a hedge fund that collapsed after squandering $6 billion in value on natural gas futures and losing $150 million of SDCERA's $175 million investment.[86] In dismissing SDCERA's claims, Judge Deborah Batts observed that the pension fund "is a sophisticated investor," pointing to their hiring of an investment advisor as ample evidence of this.[87]

There is validity to the notion that large investors with knowledge, experience, and bargaining power need less judicial protection than smaller parties, especially in bilaterally negotiated transactions.[88] However, it seems unwise from a policy standpoint to suggest to broker-dealers that they are less likely to face liability exposure where customer losses are larger, thereby incentivizing abusive practices in situations with greater damage potential. It is also important to remember that the industry standard contracts governing such transactions contain mandatory arbitration clauses that keep the vast majority of these disputes out of court.[89] To the extent arbitrators are "captured" by the financial services industry that pays their compensation,[90] there may be an even more urgent need to rethink the

[85] *See* J.P. Morgan Chase Bank, N.A. v. Controladora Comercial Mexicana S.A.B. de C.V., No. 603215/08, 2010 WL 4868142, at *1–4, *17 (N.Y. Sup. Ct. Mar. 16, 2010) (noting CCM had been entering into interest-rate hedges with J.P. Morgan and others since the 1990s and did well on a number of these transactions prior to October 2008).

[86] San Diego Cnty. Emps. Ret. Ass'n v. Maounis, 749 F. Supp. 2d 104, 127, 129 (S.D.N.Y. 2010).

[87] *Id.* at 120.

[88] *See, e.g.*, Andrea Doneff, *Arbitration Clauses in Contracts of Adhesion Trap "Sophisticated Parties" Too*, 2010 J. DISP. RESOL. 235, 236 (noting that courts, upon determining both parties are sophisticated, will typically uphold arbitration clauses).

[89] *See* Jean R. Sternlight, *Creeping Mandatory Arbitration: Is It Just?*, 57 STAN. L. REV. 1631, 1639–40 (2005) (noting the spread of mandatory arbitration clauses popularized by the securities industry to a variety of other industries).

[90] As attorney Roger Perlstadt notes, "The New York Stock Exchange arbitration system has been accused of being dominated by the securities industry." Roger J. Perlstadt, *Timing of Institutional Bias Challenges to Arbitration*, 69 U. CHI. L. REV 1983, 1987 (2002); *see also* Rosenberg v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 995 F. Supp. 190, 210 (D. Mass. 1998), *aff'd*, 170 F.3d 1 (1st Cir. 1999) (noting that the securities industry's arbitration rules "have established an entire arbitral structure dominated by the industry"); Melton, *supra* note 2, at 64 (wondering if arbitrators' receptiveness to the sophisticated investor defense when there is no basis for it "is due to industry bias").

deference given to the sophisticated investor defense in negligence claims stemming from unsuitable investment recommendations.[91]

Further developing the argument that imprecise sophistication proxies have led to the underprotection of large investors, Part III discusses three case studies involving massive investment losses suffered by institutional investors who purchased highly complex investment products. Following these case studies, Part IV offers a two-part proposal to address some of the policy dilemmas in this area.

III. THREE CASE STUDIES SUGGESTING WEALTH AND SIZE ARE POOR PROXIES FOR SOPHISTICATION

It is no doubt true that "[r]egulators generally do not spend sleepless nights worrying about the plight of millionaires who invest unsuccessfully."[92] While we might not lose any sleep over the plight of a large bank,[93] there are also many cases of large public entities losing massive sums on investments with risks they plainly did not understand, including an investment fund for five Wisconsin school districts, a fund for Jefferson County, Alabama, and a fund for various public entities in Orange County, California. Looking at these large public entities as the aggregation of "little guys" that they are, the wisdom of securities laws that radically minimize investor protection based on a customer's size or wealth seems questionable.

Prior to discussing the recent losses suffered by the Wisconsin school districts and Jefferson County, this Part first examines two case studies in which a mix of private and public entities misunderstood the risks of complex investment products and suffered massive losses as a result. The first case study dates back to the mid-1990s, when a lack of comprehension of the risk of leveraged derivatives[94] proved very costly to Proctor & Gamble (P&G), several other large companies, and Orange County. The second case study involves the SEC's now-settled suit against Goldman Sachs for arranging a series of transactions that found two large European banks on the losing end of a bet made by a hedge fund against the housing market shortly before housing prices collapsed.[95]

[91] Investors who seek to appeal adverse arbitration decisions face a daunting task in district courts where the standard of review is one of abuse of discretion. *See, e.g.*, Am. Postal Workers Union, AFL-CIO v. U.S. Postal Serv., 362 F. Supp. 2d 284, 288 (D.D.C. 2005) ("The standard of review for arbitration decisions is abuse of discretion.").

[92] Parry, *supra* note 25, at 718.

[93] *See infra* Part III.B.

[94] While a derivative is simply a side bet on the movement in value of some underlying asset, "[l]everaged derivatives are a particularly complex type of derivative, and their value can fluctuate to an even greater degree than . . . plain-vanilla derivatives." Kelley Holland & Linda Himelstein, *The Bankers Trust Tapes*, BUS. WK., Oct. 16, 1995, at 106, 110.

[95] *See SEC Enforcement Actions: Addressing Misconduct that Led To or Arose From the Financial Crisis*, SEC, http://www.sec.gov/spotlight/enf-actions-fc.shtml (last visited Nov. 11, 2012).

A. The Derivatives Woes of 1990s Corporate America

> *[T]he risks involved [with derivatives] may not be properly understood even by the most sophisticated investors, and I am supposed to be one.*
>
> —George Soros, testifying in front of Congress in April 1994[96]

In 1994, numerous institutions with extensive investing experience, including major corporations like P&G and Gibson Greetings, suffered massive losses on interest-rate vehicles known as swaps, which likely triggered realizations akin to the sentiment expressed by Soros, the legendary hedge fund manager.[97] By any metric, in 1994, P&G was a large, sophisticated investor.[98] The same can be said of Gibson Greetings, Air Products and Chemicals, Inc., the Federal Paper Board Co., and Jefferson Smurfit Corp.[99] All of these companies were burned by "the investment craze of the 1990s"[100] when they were seduced into placing costly bets on complex interest-rate swaps derivatives arranged by Bankers Trust (BT), a leader in the marketing of innovative financial products.[101] P&G suffered the largest loss, a reported $157 million, in the liquidation of its trades with BT, one of the largest trading losses ever sustained by an American company at the time.[102]

During this period, another large institutional investor, Orange County, California, lost an even greater sum of approximately $1.6 billion on interest-rate derivatives in a series of transactions arranged by Merrill

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96 *Risks that Hedge Funds Pose to the Banking System: Hearing Before the H. Comm. on Banking, Fin. & Urban Affairs*, 103d Cong. 38 (1994) (testimony of George Soros).

97 Like P&G, Soros suffered significant losses on interest-rate vehicles when the Federal Reserve Board unexpectedly raised short-term interest rates in February 1994. *See* Lawrence Malkin, *Procter & Gamble's Tale of Derivatives Woe*, INT'L HERALD TRIB., Apr. 14, 1994, at 9.

98 As of 1994, P&G was a $30-billion company. *See id.*

99 In 1993, Gibson Greetings had sales of $547 million and profits of $20 million. Carol J. Loomis, *Untangling the Derivatives Mess*, FORTUNE, Mar. 20, 1995, at 50, 54. For the fiscal year that ended September 30, 1994, Air Products and Chemicals, Inc. had sales of $3.5 billion. Air Prods. & Chems., Inc., Annual Report for the Fiscal Year Ended Sept. 30, 1994 (Form 10-K), File No. 001-04534, *available at* http://www.sec.gov/Archives/edgar/data/2969/0000950123-94-002010.txt. In 1993, Jefferson Smurfit Corp. had net sales of $2.95 billion. Jefferson Smurfit Corp., Annual Report for the Fiscal Year Ended Dec. 31, 1993 (Form 10-K), File No. 000-11951, *available at* http://www.sec.gov/Archives/edgar/data/727742/0000727742-94-000001.txt. In 1994, the Federal Paper Board Company had sales of $1.57 billion. Kenneth N. Gilpin, *International Paper Plans to Buy Federal Paper Board*, N.Y. TIMES, Nov. 7, 1995, at D4.

100 Jennifer A. Frederick, Note, *Not Just for Widows & Orphans Anymore: The Inadequacy of the Current Suitability Rules for the Derivatives Market*, 64 FORDHAM L. REV. 97, 100 (1995).

101 *See* SUNGARD BANCWARE ERISK, BANKERS TRUST: AN ERISK.COM CASE STUDY 1, *available at* http://www.prmia.org/pdf/Case_Studies/Bankers_Trust.pdf.

102 Gabriella Stern & Steven Lipin, *Procter & Gamble to Take a Charge to Close Out Two Interest-Rate Swaps*, WALL ST. J., Apr. 13, 1994, at A3. P&G was forced to take a $102 million after-tax charge on their financial statements in the third quarter of 1994. *See* Malkin, *supra* note 97.

Lynch that helped push the county into bankruptcy in 1994.[103] An investment pool, run by the Orange County treasurer for 200 local school districts, municipalities, and other public agencies, suffered the losses.[104] Merrill Lynch eventually settled a lawsuit with Orange County for $400 million.[105]

As a closer examination of these transactions suggests, each of these entities placed sizable bets on investment products with risks they seemingly did not understand despite their size and investing experience. The P&G deal structure is the most eye-opening example in this respect. In the early 1990s, P&G had a much-admired reputation for managing its debt costs, thanks to a series of deals swapping fixed-rate vehicles for floating-rate vehicles that proved to be profitable bets on a continuing decline in interest rates.[106] In October 1993, expecting interest rates to keep falling, P&G approached BT to discuss other products that could help them take advantage of interest-rate movements.[107] By November, P&G had agreed to buy a leveraged derivative product from BT for $200 million, twice what they initially planned to spend.[108]

It is important to note that leveraged derivatives are open to greater fluctuations than plain-vanilla derivatives[109] and have much greater downside potential.[110] In P&G's case, they put up $200 million to purchase a complex swap that would prove profitable if interest rates stayed within a certain range.[111] The potential upside of the transaction was shaving an estimated 0.3% off the company's annual interest bill for a total savings of $1.5 million a year,[112] a miniscule amount that illustrates how little P&G understood what it bought from BT.

Even after the Federal Reserve Board's February 1994 announcement that it would raise short-term rates for the first time in five years, P&G continued to put money on the table with BT, essentially doubling down on a "wedding band" swap in hopes that rates would swing in its favor.[113] According to reports, P&G did not realize how dire the situation was until

103 *See* Andrew Pollack & Leslie Wayne, *Ending Suit, Merrill Lynch to Pay California County $400 Million*, N.Y. TIMES, June 3, 1998, at A1.

104 *Id.*

105 *Id.* The derivatives purchased by the Orange County investment pool were a more direct bet on the interest-rate trend line than the products sold by BT to corporate investors. *See* Hal S. Scott, *Liability of Derivatives Dealers*, *in* THE FUTURE FOR THE GLOBAL SECURITIES MARKET: LEGAL AND REGULATORY ASPECTS 271, 271 (Fidelis Oditah ed., 1996).

106 *See* Loomis, *supra* note 99, at 62.

107 *Id.*

108 *Id.* at 64.

109 *See supra* note 94.

110 *See* Loomis, *supra* note 99, at 68.

111 *Id.* at 54, 64.

112 *Id.* at 64.

113 *Id.*

March 1994 when the company shifted into damage control mode in its dealings with BT.[114]

In a series of settlements, BT wrote off some $423 million in customer losses on interest-rate swaps,[115] spurred in part by the existence of audio tapes on which BT employees could be heard gloating about how little their customers understood the risks of such transactions.[116] As for P&G, its CEO publicly pledged that the company had learned its lesson on the dangers of derivatives.[117] Despite such promises, in the ensuing years, institutional investors have had great difficulty resisting the riskiest "latest new things"[118] cooked up by financial products innovators like BT. The next case study offers evidence of this.

B. *Doing God's Work*[119]

> *"[T]he whole building is about to collapse . . . . Only potential survivor, the fabulous Fab . . . standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all of the implications of those monstruosities [sic]!!!"*
>
> —Fabrice "Fab" Tourre, the Goldman Sachs salesman at the center of the ABACUS deal, in an e-mail to a friend in January 2007[120]

The investment craze of the 2000s was the CDO.[121] In a CDO transaction brokered by Tourre, IKB Deutsche Industriebank (IKB), a

[114] *See id.*

[115] *Id.* at 66. BT settled with most of its institutional purchasers who suffered losses on derivatives, including P&G, Gibson Greetings, Air Products and Chemicals, Inc., and the Federal Paper Board Company. *See* SUNGARD BANCWARE ERISK, *supra* note 101, at 1.

[116] At a videotaped training session for new employees, explaining a hypothetical derivative transaction among Sony, IBM, and BT, a BT employee explained, "[W]hat Bankers Trust can do for Sony and IBM is get in the middle and rip them off . . . . Let me take that back. I just realized that I'm being filmed." Holland & Himelstein, *supra* note 94, at 108.

[117] In 1994, P&G CEO and Chairman Edwin Artzt remarked, "Derivatives like these are dangerous, and we were badly burned . . . . We won't let this happen again." *P&G Reports $102-Million Derivatives Loss*, L.A. TIMES, Apr. 13, 1994, at D2.

[118] White, *supra* note 83, at 743.

[119] In an unfortunate bit of timing, just prior to the dissemination of revelations about the ABACUS deal, Goldman Sachs managing partner Lloyd Blankfein was quoted praising the firm's investment bankers for "doing God's work." *See* John Arlidge & Philip Beresford, *Inside the Goldmine*, SUNDAY TIMES, Nov. 8, 2009, at 12, 24.

[120] Gregory Zuckerman et al., *U.S. Charges Goldman Sachs with Fraud*, WALL ST. J., Apr. 17–18, 2010, at A1.

[121] A CDO is a security whose value and payments are derived from a portfolio of underlying fixed-income assets. The ABACUS transaction involved: (1) so-called synthetic CDOs (which do not own the underlying assets in contrast to traditional CDOs); (2) credit default swaps (CDSs) which, much like an insurance policy, can be used by bond owners to hedge the risk of default (or to speculate on the creditworthiness of entities without purchasing or selling their bonds); and (3) residential mortgage-backed securities (RMBS) (bonds backed by pools of residential real estate mortgages). *See* Philip Whalen & Kara Tan Bhala, *Goldman Sachs and the ABACUS Deal*, SEVEN PILLARS INST. FOR GLOBAL

German bank, and ABN Amro, a Dutch bank, lost a combined $1 billion on an ill-timed bet on the home loan market just prior to a dramatic reversal in housing prices reminiscent of the interest-rate reversal that proved costly to companies like P&G in 1994.[122] The transactions involved derivatives tied to risky subprime residential mortgage loans.[123] While ABN Amro ultimately lost more money than IKB,[124] much of the criticism of Goldman Sachs concerned their dealings with IKB and ACA Management (ACA), another sophisticated player chosen as the deal's portfolio selection agent that also suffered a large loss.[125]

Since 2007, IKB had been purchasing CDOs backed by prime and subprime mortgages.[126] Like many other large institutional investors, they came to Goldman Sachs seeking objective advice on these investments.[127] According to reports, by late 2006, IKB told Goldman Sachs it was "no longer comfortable investing" in such products if they had not been vetted by an independent third party or if the trades did not involve a collateral manager.[128]

Around this time, John Paulson, manager of the New York-based hedge fund Paulson & Co., approached Goldman Sachs asking it to assemble a CDO, later dubbed ABACUS 2007–AC1, which he could use to short the housing market, proposing a deal that would net Goldman Sachs a $15 million fee.[129] Attempting to satisfy both customers, Tourre and Goldman Sachs responded to IKB's skepticism about the proposed Abacus deal by selecting ACA as a collateral manager.[130] Crucially, the marketing materials for ABACUS failed to disclose that despite ACA's participation, the selection process was principally done by Paulson & Co., with the hedge fund stacking the deck in its favor.[131] The SEC later contended that

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FIN. & ETHICS, http://sevenpillarsinstitute.org/case-studies/goldman-sachs-and-the-abacus-deal (last visited Nov. 12, 2012).

[122] *See* Marc Pitzke, *Wall Street vs. Washington: Goldman Sachs Goes on the Offensive*, SPIEGEL ONLINE (Apr. 22, 2010, 3:19 PM), http://www.spiegel.de/international/business/0,1518,690527,00.html.

[123] *See* Whalen & Bhala, *supra* note 121.

[124] *See supra* note 122.

[125] As a result of the ABACUS fallout, ACA's parent company failed in late 2007. *See* Whalen & Bhala, *supra* note 121.

[126] *See* Zachary A. Goldfarb, *SEC Confident on IKB Part of Goldman Suit*, WASH. POST, Apr. 24, 2010, at A8.

[127] *See id.*

[128] Gregory Corcoran, *SEC v. Goldman: Meet One Abacus Investor*, WALL ST. J. DEAL J. (Apr. 16, 2010, 12:26 PM), http://blogs.wsj.com/deals/2010/04/16/sec-v-goldman-meet-one-abacus-investor/.

[129] *See* Whalen & Bhala, *supra* note 121.

[130] *See* Pitzke, *supra* note 122.

[131] *See* Andrew Ross Sorkin, *When Deals on Wall Street Resemble a Casino Wager*, N.Y. TIMES, Apr. 20, 2010, at B1.

this omission and other misstatements by Goldman Sachs defrauded investors, including IKB and ABN Amro.[132]

From February to April of 2007, Goldman Sachs marketed ABACUS to its customers.[133] In April, IKB invested $150 million in the deal. Nine months later, the collapse of the housing market meant IKB's investment was essentially worthless,[134] as was the $841 million investment of ABN Amro.[135] In contrast to the large losses of IKB, ABN Amro, and ACA,[136] Paulson & Co. netted approximately $1 billion.[137] The tally that best underlines the difficulty even the most sophisticated institutions have evaluating the risks of innovative products was Goldman Sachs's loss of more than $100 million, wiping out their $15 million fee, despite their knowledge of John Paulson's pessimism about the housing market.[138]

The legal fallout was a settlement with the SEC whereby Goldman Sachs agreed to pay a penalty of $550 million and issued a statement that did not admit wrongdoing but acknowledged its marketing materials "contained incomplete information."[139] In the end, $150 million of the SEC settlement went to IKB and $100 million went to Royal Bank of Scotland, which purchased ABN Amro.[140] The business fallout was a costly twelve-billion-euro bailout of IKB by Germany[141] and IKB's subsequent sale to a private equity firm in 2009.[142]

C. Trouble in Milwaukee and Jefferson County

In a deal more troubling than the ABACUS debacle in its implications with respect to sophistication proxies, five Wisconsin school districts lost

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[132] *See* Press Release, SEC, SEC Charges Goldman Sachs with Fraud in Structuring and Marketing of CDO Tied to Subprime Mortgages (Apr. 16, 2010), *available at* http://www.sec.gov/news/press/2010/2010-59.htm. Evidence emerged to contradict the SEC's claim that ACA had been defrauded. Goldfarb, *supra* note 126 (noting that reports that a Paulson & Co. deputy had informed ACA that the fund intended to short the securities "rais[ed] serious questions about whether ACA was misled or defrauded").

[133] *See* Corcoran, *supra* note 128.

[134] *See id.*

[135] *See* Pitzke, *supra* note 122.

[136] Estimates of the loss suffered by ACA are as high as $900 million. *See* Whalen & Bhala, *supra* note 121.

[137] *See id.*

[138] *See* Pitzke, *supra* note 122.

[139] DealBook, *Goldman Settles with S.E.C. for $550 Million*, DEALB%K (July 15, 2010, 4:17 PM), http://dealbook.nytimes.com/2010/07/15/goldman-to-settle-with-s-e-c-for-550-million.

[140] *See Goldman's Deep Pockets May Still Attract Lawsuits*, REUTERS (July 16, 2010, 3:44 PM), http://www.reuters.com/article/2010/07/16/goldman-rbs-idCNLDE66F0TD20100716?rpc=44.

[141] *See* Karin Matussek, *Ex-IKB CEO Convicted of Misleading Investors About Bank's Subprime Risks*, BLOOMBERG (July 14, 2010, 6:09 AM), http://www.bloomberg.com/news/2010-07-14/ex-ikb-chief-ortseifen-convicted-of-market-manipulation-over-subprime.html.

[142] *See* Pitzke, *supra* note 122. IKB's CEO was given a ten-month suspended sentence for misstating company assets. *See* Matussek, *supra* note 141.

$200 million in pooled funds invested in a trust set up to finance $400 million in unfunded pension and health care liabilities.[143] The schools' investment trust was set up by David Noack, a senior vice president in the Milwaukee office of investment bank Stifel Financial (Stifel).[144] From June to December 2006, Noack invested the schools' funds in notes linked to highly leveraged synthetic CDOs sold by RBC Capital Markets LLC (RBC).[145] The deal involved an arbitrage strategy where the schools would borrow money and invest it in AA-minus-rated corporate debt that would yield more than the schools would pay in interest on the loans.[146] An additional layer of complexity was added when the lending bank, Depfa, of Ireland, requested that the securities be structured as CDOs.[147] As in the ABACUS transaction, ACA acted as a portfolio selection agent for RBC, along with UBS.[148]

Noack reportedly assured his clients that it would take "15 Enrons" to put their capital in jeopardy and that the CDOs were as safe as U.S. Treasuries.[149] Such statements suggest either an audacious level of mendacity or, more likely, how little Noack understood the risks of leveraged CDOs despite being the kind of well-compensated advisor hired by large public entities.

Ultimately, the trust collapsed, with the schools losing all of their $37 million initial investment and Depfa seizing $163 million in collateral that secured the loans. Not surprisingly, the SEC is pursuing an enforcement action against Stifel. Instead of settling quickly like Goldman Sachs and others, Stifel is currently defending the suit,[150] while RBC settled and agreed to pay a $30 million penalty.[151] Although a portion of penalties paid to the SEC should find their way to the schools' impoverished coffers, these amounts, together with any settlements recovered by the schools in private actions, will likely fall far short of covering the $200 million loss.[152]

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[143] *See* Gretchen Morgenson, *Finger-Pointing in the Fog*, N.Y. TIMES, Aug. 21, 2011, at BU1.

[144] *See id.*

[145] *See* Press Release, SEC, SEC Charges RBC Capital Markets in Sale of Unsuitable CDO Investments to Wisconsin School Districts (Sept. 27, 2011), *available at* http://www.sec.gov/news/press/2011/2011-191.htm.

[146] *See SEC Sues Over Wis. Schools' $200M Loss*, USA TODAY, Aug. 11, 2011, at 5B; Press Release, *supra* note 145.

[147] *See* Morgenson, *supra* note 143.

[148] *See id.*

[149] Press Release, SEC, SEC Charges Stifel, Nicolaus & Co. and Executive with Fraud in Sale of Investments to Wisconsin School Districts (Aug. 10, 2011), *available at* http://www.sec.gov/news/press/2011/2011-165.htm.

[150] *See* Gretchen Morgenson, *Police Protection, Please, for Municipal Bonds*, N.Y. TIMES, Aug. 5, 2012, at BU1.

[151] Press Release, *supra* note 145. Stifel is also pursuing a claim against RBC, alleging the bank did not disclose conflicts of interest in setting up the transaction. Morgenson, *supra* note 143.

[152] *See* Complaint, SEC v. Stifel, Nicolaus & Co., No. 2:11-cv-00755 (E.D. Wis. Aug. 10, 2011); Thomas O. Gorman, *A Tale of Five School Districts and a Trusted Advisor*, SEC ACTIONS (Aug. 11,

Like the Wisconsin schools, Jefferson County, Alabama, is another large public entity that recently suffered massive losses stemming from unanticipated risks associated with complex investment products. In the late 1990s, in an attempt to fund liabilities stemming from environmental violations in its sewer system, Jefferson County began issuing bonds that by the early 2000s had a significant interest-rate swap component as an ostensible hedge arranged by J.P. Morgan Chase and Goldman Sachs.[153] By 2008, the would-be hedge had resulted in massive losses, and Jefferson County's debt was downgraded to junk status.[154] All told, they eventually ran up $647 million in losses and fees.[155] While some losses were later cancelled as part of an SEC settlement,[156] this did not prevent the county from filing for bankruptcy in November 2011, becoming the most expensive bankruptcy in U.S. history.[157] The Jefferson County bankruptcy, fueled by losses on complex financial investments, dwarfed even the Orange County bankruptcy of nearly two decades earlier,[158] although both stemmed in part from a similar cause: misguided bets on interest-rate derivatives. In the aftermath of the Jefferson County bankruptcy, the criticism of the participating investment banks was severe, with one attorney-banker who worked with the county labeling J.P. Morgan Chase and Goldman Sachs as nothing more than "bag-men, furthering the corruption" of local officials.[159]

The Wisconsin schools, Jefferson County, and Orange County are not the only public entities that suffered massive investment losses on complex financial investments over the last few decades.[160] As examples of a broader

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2011, 3:01 AM), http://www.secactions.com/?p=3523; Press Release, *supra* note 145; Press Release, *supra* note 149.

[153] *See* White, *supra* note 83, at 735–38 ("For many years it was known in financial circles . . . that J.P. Morgan was abusing Jefferson County in interest rate swap transactions. . . . '[A]buse' understates the seriousness of J.P. Morgan's actions.").

[154] *See* Martin Z. Braun, *Alabama County's Debt Cut to Junk on Credit Squeeze*, BLOOMBERG (Feb. 29, 2008, 8:29 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=adq8QPXJc5zo&refer=munibonds.

[155] J.P. Morgan agreed to forgive the $647 million and pay Jefferson County $50 million. *See* Brian Burnsed, *Bond Debacle Sinks Jefferson County*, BLOOMBERGBUSINESSWEEK (Nov. 8, 2009), http://www.businessweek.com/bwdaily/dnflash/content/nov2009/db2009118_722581.htm.

[156] *See id.*

[157] *See* Mary Williams Walsh, *When a County Runs Off the Cliff*, N.Y. TIMES, Feb. 19, 2012, at BU1; Barnett Wright, *Jefferson County Commission Votes 4–1 to File Nation's Largest Municipal Bankruptcy*, BIRMINGHAM NEWS (Nov. 9, 2011, 3:48 PM), http://blog.al.com/spotnews/2011/11/jefferson_county_commission_vo_14.html.

[158] *See* Floyd Norris, *Orange County Crisis Jolts Bond Market: From a Bankruptcy, Fears About Losses*, N.Y. TIMES, Dec. 8, 1994, at D1.

[159] White, *supra* note 83, at 738. The former county commissioner was ultimately convicted for taking kickbacks. *See* Burnsed, *supra* note 155.

[160] In the mid-1980s, the state of West Virginia sustained $280 million in losses on government bonds in a fund managed by Morgan Stanley. A West Virginia state appellate court set aside a $56.8 million jury verdict for the state. State v. Morgan Stanley & Co., 459 S.E.2d 906, 910, 913 (W. Va.

phenomenon, they serve to illustrate the problems created by a system in which institutional investors, treated as sophisticated because of their size, are disadvantaged not once, but twice in the financial marketplace. They are taken advantage of on the front end of transactions by incompetent or unscrupulous actors like Stifel's Noack and the "bag-men" at J.P. Morgan Chase and Goldman Sachs.[161] And they are disadvantaged on the back end by the diminished legal protections afforded to wealthy investors in court and arbitration. To those indifferent toward the misfortunes of large banks and corporate behemoths like P&G, the damage to the coffers of school districts and municipalities already strapped for funds emphasizes the extent to which these debacles harm the greater public.

The reaction of some members of the Wall Street community to the revelations about ABACUS and the Jefferson County bond losses suggests a willingness to rethink the treatment of investor sophistication. As a former head of the Federal Reserve Bank of New York remarked, "Wall Street cannot pretend anymore that the treasurer of a small town in the Midwest on a civil service salary and no analytical support has the same level of sophistication as a specialized hedge fund."[162] Even Goldman Sachs implicitly acknowledged this point in a May 2010 statement that promised it would review the firm's practices with respect to, among other things, "the suitability of products for different types of clients."[163]

While some commentators acknowledge that these case studies suggest not all large investors should be treated as equally sophisticated, others have not divined the same lesson. Thus far, financial regulatory agencies like the SEC seem to view the antifraud provisions of securities laws as sufficient to police these sorts of abuses.[164] However, there are two problems with this sort of approach. First, successful fraud claims require a

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1995). In the early 1990s, a nonprofit entity that operates the City Colleges of Chicago sustained $50 million in losses on a $100 million investment in interest-rate-sensitive CMOs arranged by Westcap Securities. A Seventh Circuit district court granted Westcap's motion to compel arbitration. Cmty. Coll. Dist. No. 508 v. Westcap Gov't Sec., Inc., No. 94 C 1920, 1994 WL 530849, at *7 (N.D. Ill. Sept. 29, 1994).

[161] White, *supra* note 83, at 738.

[162] *Seller's Remorse?*, *supra* note 25.

[163] *Id.*

[164] Events in early 2012 suggest the SEC is rethinking this position in some contexts. The SEC announced a review of the treatment of public entities by broker-dealers. Seemingly acknowledging large public investors are less sophisticated than private institutions, the SEC has indicated it will hold broker-dealers to a higher standard of care under the Financial Industry Regulatory Authority's (FINRA) suitability rules when transacting securities in a public entity's account. Tellingly, although the relevant regulations remain unchanged, the SEC has begun referring to such customers as "quasi-institutional" investors. *See* KATTENMUCHINROSENMAN LLP, THE SEC'S HEIGHTENED SCRUTINY OF BROKER-DEALER MUNICIPAL SECURITIES UNDERWRITING AND PUBLIC ENTITY SALES PRACTICES (2012), *available at* http://www.kattenlaw.com/files/upload/The_SECs_Heightened_Scrutiny_of_Broker-Dealer_Municipal_Securities_Underwriting_and_Public_Entity_Sales_Practices.pdf.

showing of scienter.[165] Unless a customer is defrauded by a company like BT whose employees are willing to brag on video and audiotape about their misdeeds, this can be a major obstacle for a plaintiff. Second, and perhaps more importantly, "litigation is a poor substitute for regulation."[166] Accordingly, an ex ante approach to this problem would be more efficient. In Part IV, two ex ante proposals are detailed: (1) revising the statutory benchmarks for sophistication to better reflect inflationary trends and the ability to bear economic risk and (2) raising the broker-dealers' standard of care to a uniform fiduciary standard on par with that of investment advisers for customers both large and small.

IV. Proposal for Reforming the Treatment of Sophistication in Statutory Exemptions and Suitability Cases

A. Consideration of Prior Proposals

As noted earlier, criticisms of wealth- and size-based sophistication proxies date back to shortly after the introduction of the Regulation D safe harbor for nonpublic offerings.[167] These criticisms have intensified in the wake of large losses by institutional investors as a result of the financial crisis of 2008. The criticisms typically propose one of two types of solutions.

The first type argues that some sort of exam testing an investor's financial knowledge (or that of the investor's "purchaser representative") would be an efficient substitute for the current heuristic wealth- and size-based proxies. Typically, commentators who stress that wealth- and size-based sophistication proxies are both over- and underinclusive tend to prefer a "financial literary test" as a solution.[168]

To the extent these exam-based proposals emphasize how imprecise the current proxies are, I am sympathetic to them. However, there are important critiques of such proposals. As the case studies in Part III indicate, there is a tremendous range of contemporary investment products,

[165] While there are strict liability violations of the federal securities laws where scienter is not required (e.g., claims brought under § 12(2) of the 1934 Act or § 17(a)(2) and (3) of the 1933 Act), the Supreme Court has stated that scienter is an essential element of any private securities fraud action brought under § 10(b) of the 1934 Act and Rule 10b-5. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976). In *Aaron v. SEC*, the Court extended this holding to cover SEC enforcement actions brought under § 10(b) and § 17(a)(1) of the 1933 Act. 446 U.S. 680, 696 (1980). Under the Private Securities Litigation Reform Act of 1995, private plaintiffs must satisfy a heightened pleading standard with respect to scienter. 15 U.S.C. § 78u-4(b)(1) (2006).

[166] Sorkin, *supra* note 131 (quoting Professor Erik F. Gerding).

[167] *See supra* note 73 and accompanying text.

[168] *See* Finger, *supra* note 22, at 763–66; Mary Kissel, Op-Ed., *So Who Needs Wall Street?*, WALL ST. J., Oct. 29–30, 2011, at A13 (interviewing the founder of an online trading platform who argues "an SEC-administered 'financial literacy test'" would offer more effective investor protection than the current approach).

including everything from garden-variety equity securities, debt instruments, and plain-vanilla derivatives to highly leveraged interest-rate swaps and CDOs. Thus, financial literacy can mean very different things in different contexts, as the suitability guidelines propagated by SROs note.[169] Accordingly, it is hard to imagine any one exam of a reasonable length that could accurately measure an investor's or a purchaser representative's relevant knowledge in all such contexts. Given this, not one but many financial literary exams with varying levels of difficulty and emphases would need to be devised. While that may not be an insurmountable problem, it suggests this sort of proposal may not be as practical as it appears.

A related concern with exam-based proposals stems from the fact that the staggering complexity of many contemporary investment products means financial literacy no longer affords the protection it once did. A January 2012 notice by the Financial Industry Regulatory Authority (FINRA) to its members on the "heightened supervision of complex products" conveys this point well.[170] The notice offers a laundry list of dizzyingly intricate products, including:

> Structured notes with "worst-of" features, which provide payoffs that depend upon the worst performing reference index in a pre-specified group [and may] limit return of principal . . . if either reference index falls by a stated percentage (*e.g.*, 30 percent) or if any of the reference indices decline in value . . . [and] structured notes [with] a payout structure that tracks the upside performance of a reference asset one-for-four, but if the reference asset's performance exceeds a specified threshold the payoff is . . . much lower . . . regardless of how it performs afterward.[171]

While it is conceivable that the FINRA members who design such byzantine products understand the risks for investors, the idea that institutions on the buy side can easily hire purchaser representatives to provide them with sufficient sophistication in such contexts strains credulity.

A final objection to exam-based proposals relates to the underlying concern in these critiques about the unfairness of barring poorer investors from participating in investment opportunities available to wealthy

[169] The old National Association of Securities Dealers (NASD) suitability rule, which was succeeded by FINRA's Rule 2111 on July 9, 2012, stressed that a relevant consideration in determining an institutional investor's ability to evaluate risk is "the complexity of the security or securities involved." NASD Rule 2310, IM-2310-3 (2010), Suitability Obligations to Institutional Customers, *available at* http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=3638&record_id.

[170] FINRA, REGULATORY NOTICE 12-03: COMPLEX PRODUCTS: HEIGHTENED SUPERVISION OF COMPLEX PRODUCTS (2012), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p125397.pdf.

[171] *Id.* at 4, 5.

investors.[172] In light of the misfortunes suffered by entities like the Wisconsin schools, Jefferson County, and Orange County that many would argue are not, and should not be, in the business of betting on CDOs and swaps with public money, it seems unwise to implement a policy change that makes it easier for members of the public with limited funds to learn the same hard lessons as these entities.

A second type of proposal focuses on the fundamental flaws in the federal securities laws, seeing imprecise sophistication proxies as symptomatic of larger flaws. For example, Professor Thomas Lee Hazen argues that "whereas regulation of investments in securities and derivatives occurs primarily through disclosure requirements," the close similarities between gambling, insurance contracts, and financial investing suggest that a regulatory approach modeled on the insurance industry would be more effective than the current laws.[173] While pointing out the general "deregulatory trend in gambling activities" and "non-securities derivatives," Hazen argues for a more "paternalistic approach" to financial regulation modeled on the insurance regulatory approach of "interpret[ing] insurance contracts to protect insureds."[174]

While many advocates of market efficiency would object to this self-described "paternalistic" approach on ideological grounds,[175] I do not find such objections persuasive in light of the losses and abuses detailed in Part III. Nonetheless, the considerable influence of antipaternalist advocates in the current debate on financial regulation suggests an overhaul of securities laws modeled on Hazen's openly "paternalistic approach"[176] is not politically pragmatic enough to succeed.

B. Proposal for Modifying the Accredited Investor Standards and Other Statutory Exemptions

Because they represent the lowest benchmarks for sophistication-based exemptions and the most outmoded with respect to inflation, Rule 215 and Regulation D's \$1 million net worth standard for individuals and married couples, \$5 million standard for institutions, \$200,000 annual income standard for individuals, and \$300,000 standard for married couples are the proxies most in need of reform. Perhaps for these reasons, the SEC recently

[172] A recent news article noted the "outrage" about average investors being shut out of a contemplated private offering of shares of Facebook to Goldman Sachs's "wealthiest clients," a plan later scuttled in favor of an overseas offering due to regulatory concerns. Sullivan, *supra* note 16.

[173] Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 375, 377–78 (2005).

[174] *Id.* at 430–40.

[175] For a sense of the antipaternalist arguments against financial regulation, see generally Shadab, *supra* note 20.

[176] Hazen, *supra* note 173, at 431.

finalized its treatment of a minor modification to the standards as directed by the Dodd–Frank Act.[177]

In a December 2011 release, the SEC announced it will exclude the value of an individual or married couple's primary residence from the net worth calculation, resulting in a constructive increase to the $1 million net worth standard for accredited investors who are homeowners.[178] Somewhat blunting the impact of the change, however, indebtedness secured by a primary residence will not be treated as a liability unless the debt exceeds the home's current market value.[179]

Rather than a constructive increase in one of the four benchmarks, I would like to see more substantive changes, applied equally to the $1 million and $5 million net worth benchmarks and the $200,000 and $300,000 annual income benchmarks. These changes would better reflect the most common justifications for wealth- and size-based sophistication proxies: (1) the increased ability of wealthy investors to "purchase" sophistication by hiring advisors and (2) the increased ability of wealthy investors to bear economic risk associated with investments.

To better reflect the first justification for sophistication proxies, all four benchmarks should be immediately adjusted to reflect the inflationary erosion of the purchasing power represented by Regulation D's thirty-year-old benchmarks.[180] As discussed in Part I, this would increase the net worth standard for individuals and married couples to $2.37 million and the standard for institutions to $11.87 million. This would also raise the annual income standards to $475,000 for individuals and $712,000 for married couples. In order to meet the continuous inflationary strain on buying power, all four benchmarks should be revisited every five years and readjusted by regulations to reflect any real-dollar-value impact of changes in an appropriate core price index. While there has been more modest inflationary erosion of the benchmarks for the Rule 144A QIB exemption and the qualified purchasers exemption in the 1940 Act, the same forward-thinking modifications should be applied to these benchmarks as well.

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[177] *See* Dodd–Frank Act § 413(b), Pub. L. No. 111-203, 124 Stat. 1376, 1578 (2010); Net Worth Standard for Accredited Investors, Securities Act Release No. 33-9287, Investment Company Act Release No. 29,891, 76 Fed. Reg. 81,793, 81,794 (Dec. 29, 2011).

[178] Some of the nuances are intended to avoid penalizing an investor whose home mortgage is underwater. *See* Kenneth Muller et al., *Securities Registration: A Revised Net Worth Standard for Accredited Investors*, INSIGHTS, Mar. 2011, at 17.

[179] *See* Net Worth Standard for Accredited Investors, 76 Fed. Reg. at 81,795–96.

[180] In a different context, the SEC has finally acknowledged the wisdom of inflation-sensitive benchmarks. Recent revisions to Rule 205-3 of the Advisors Act will adjust for inflation the benchmarks for "qualified clients" that permit RIAs to charge performance-based fees to such customers. Inflation adjustments will continue in the future. *See* KENNETH J. BERMAN ET AL., AMENDMENTS TO THE ADVISERS ACT PERFORMANCE FEE RULE (2012), http://www.debevoise.com/files/Publication/62df9c46-6b09-4597-b002-7c1c0b799949/Presentation/PublicationAttachment/ba2a6c12-35ee-4eac-b10f-873b72a20ab6/AmendmentstoTheAdvisersActPerformanceFeeRule.pdf.

Although such steps would help ensure that the accredited investor standards and other benchmarks better track the ability of wealthy investors to "purchase" sophistication by hiring advisors, they would not address the second justification for such proxies, namely, that wealthy investors can better bear the economic risk associated with investments.[181] In theory, no investor can better afford to lose 100% of their capital, regardless of their wealth. Nonetheless, there is no stipulation in Regulation D or Rule 215 that accredited investors cannot invest 100% of their net worth in an exempt offering. To accurately reflect the "ability to bear the risk" justification, the benchmarks in Rule 215 and Regulation D should be modified to include what I call a "diversification-sensitive" component. Individual investors, married couples, and institutions who meet the respective benchmarks should be limited to investing up to 25% of their net worth in a § 4(5)-exempt offering or a Regulation D private placement.[182]

Although a 25% cap intended to encourage diversification on purchases by accredited investors would impede access to capital for businesses that rely on such low-cost exemptions, the impact could be softened by allowing individual investors, married couples, and institutional investors possessing double the net worth or annual income benchmarks to invest up to 50% of their net worth in exempt offerings while letting investors who can triple these benchmarks to invest up to 100%. Although an argument could be made that these graduated caps do not make sense to the extent they still enable an investor with triple the minimum net worth standard to lose everything on an investment, cap removal at a "super-net-worth" or a "super-annual-income" level has the virtue of making the proposal more politically pragmatic.

Although the recent revision to the Regulation D and Rule 215 benchmarks falls short of extensive changes, the Dodd–Frank Act gives the SEC the ability to make significant revisions in this area. After July 21, 2014, the net worth standard of $1 million will be open to adjustment by future rulemaking, with subsequent adjustments occurring "not less

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[181] Net Worth Standard for Accredited Investors, 76 Fed. Reg. at 81,794.

[182] Recent commentators have proposed similar modifications. Andrew Abramowitz, a capital markets attorney, suggests a better accredited investor definition would limit what percentage of their net worth people can invest and have "a prohibition on participation in a new private placement if the investor's previous investments in illiquid securities constitute a specified share of [the] investor's liquid assets." Sullivan, *supra* note 16. Professor John C. Coffee, Jr. argues that the definition should contain a standard for diversification capping investments in unregulated securities at 15% to 20% of net worth. *Id.* Although skeptics might suggest a diversification-sensitive component is unnecessary given that modern portfolio theory has conclusively demonstrated the benefits of diversification to investors, it is open to debate whether investors have taken such lessons to heart. *See, e.g.*, Stephan Abraham, *The Pitfalls of Diversification*, INVESTOPEDIA (June 7, 2012), http://www.investopedia.com/articles/basics/12/pitfalls-of-diversification.asp#axzz1yO5qSLXo (arguing that diversification may not be "all that it's cracked up to be" from a cost–benefit standpoint).

frequently than once every 4 years thereafter."[183] In addition, § 415 of the Dodd–Frank Act requires the Comptroller General to undertake a study examining "the appropriate criteria for determining the financial thresholds . . . needed to qualify for accredited investor status and eligibility to invest in private funds."[184] Additionally, § 413(b)(2)(B) of the Dodd–Frank Act gives the SEC authority to:

> by notice and comment rulemaking, make such adjustments to the definition of the term "accredited investor[,"] as defined in section 230.215 of title 17, Code of Federal Regulations, or any successor thereto, as such term applies to natural persons, as the Commission may deem appropriate for the protection of investors, in the public interest, and in light of the economy.[185]

Although this passage unfortunately exempts the definition of accredited institutional investors from such revisions, the language allows for the wholesale modification of Regulation D's sophistication proxies for individuals if the SEC can be convinced the current benchmarks are not in the public interest.

C. Proposal for Modifying the Standard of Care Imposed on Broker-Dealers

Under the Advisers Act, it is well-established that RIAs have a fiduciary duty to their customers, meaning that the customers' interests must take priority in any transaction.[186] In contrast, the debate over whether broker-dealers[187] owe fiduciary duties to their customers has been long and contentious.[188] Prior to the passage of the Advisers Act, early twentieth-

[183] Dodd–Frank Act § 413(b)(2)(A), Pub. L. No. 111-203, 124 Stat. 1376, 1578 (2010). Although the statute is not completely clear on this point, the income standards will presumably also be open to inflation adjustments. *See* J. Robert Brown Jr., *The Dodd–Frank Wall Street Reform Act and the SEC: Profound Bits and Pieces (Accredited Investor Standard)*, THERACETOTHEBOTTOM.ORG (Aug. 5, 2010, 9:00 AM), http://www.theracetothebottom.org/dodd-frank/the-dodd-frank-wall-street-reform-act-and-the-sec-profound-b-4.html.

[184] Dodd–Frank Act § 415, 124 Stat. at 1578; *see also* Net Worth Standard for Accredited Investors, 76 Fed. Reg. at 81,795 (discussing possibility of review).

[185] Dodd–Frank Act § 413(b)(2)(B), 124 Stat. at 1578.

[186] *See supra* note 27 and accompanying text.

[187] While RIAs are advisers or firms in the investment advising business that have registered with the SEC or a state securities board, broker-dealers are simply individuals or firms in the business of buying and selling securities.

[188] In 1999, the SEC proposed Advisers Act Rule 202(a)(11)-1, which would have allowed brokers to avoid fiduciary obligations even if they did not comply with the requirements of the broker-dealer exclusion in the Advisers Act, replacing the exclusion's compensation rules with a modest disclosure requirement. The proposal generated 1700 comment letters. After shelving the proposed rule for several years, the SEC reproposed the rule in January 2005 and adopted it in April 2005. The D.C. Circuit Court of Appeals struck it down in 2007, Fin. Planning Ass'n v. SEC, 482 F.3d 481, 493 (D.C. Cir. 2007), which "threw into confusion the fundamental issues" in this area, Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395, 410–12 (2010). By 2009, the

century courts typically viewed brokers as fiduciaries.[189] In 1940, the Advisers Act bifurcated the regulatory structure, leaving some observers with the impression that brokers who were exempt did not owe fiduciary duties to customers, despite the fact that many of them have long provided advice to their clients.[190] Adding to the confusion, there is still a minority rule holding that broker-dealers are fiduciaries whether or not they are RIAs.[191]

If broker-dealers do not owe investors fiduciary duties, the brokerage firm and its employees must merely adhere to an ordinary negligence standard of care in dealing with customers.[192] For wronged investors, this makes recovery in suitability cases—already difficult for sophisticated customers—all but impossible. In contrast, as a fiduciary, RIAs owe clients an affirmative duty to disclose material information.[193] If a brokerage firm is held to this standard, it becomes a blatant violation of duty to arrange a transaction that a firm employee believes is a terrible investment for one party, as Goldman Sachs's Fabrice Tourre allegedly did in the ABACUS transaction.

While lobbyists for broker-dealers assert that the imposition of an unambiguous fiduciary duty would seriously harm the securities industry business model,[194] there are forceful arguments on behalf of imposing one. The primary such argument, as the SEC notes, is that customers are frequently unsure whether or not they are owed a fiduciary duty in securities transactions.[195] There are several reasons for this.

dynamics of the debate had shifted, with an Obama Administration white paper calling for legislative reform to impose a fiduciary duty on brokers who provide advice to clients. *Id.* at 397.

[189] *See, e.g.*, Batterson v. Raymond, 149 N.Y.S. 706, 711 (Sup. Ct. 1914); Haight v. Haight & Freese Co., 92 N.Y.S. 934, 936 (Sup. Ct. 1905); Wahl v. Tracy, 121 N.W. 660, 661 (Wis. 1909).

[190] *See* Laby, *supra* note 188, at 400 ("Brokers have always provided advice to their brokerage customers . . . .").

[191] United States v. Wolfson, Nos. S1 00 Cr. 628(JGK), S1 02 Cr. 1588(JGK), 2008 WL 1969730, at *2 (S.D.N.Y. May 5, 2008); Duffy v. Cavalier, 264 Cal. Rptr. 740, 751 (Ct. App. 1989).

[192] While the contemporary courts cited in note 191 *supra* have found broker-dealers subject to a fiduciary duty, the typical standard of care imposed is one of good faith and fair dealing. *See* SECTION 913 STUDY, *supra* note 24, at 70–71.

[193] *See* SEC v. Bolla, 401 F. Supp. 2d 43, 66–67 (D.D.C. 2005) (noting that with the Advisers Act, Congress created "a fiduciary duty on the part of investment advisers to exercise good faith and fully and fairly disclose all material facts to their clients, and an affirmative obligation to employ reasonable care to avoid misleading [their] clients" (alteration in original) (quoting Morris v. Wachovia Sec., Inc., 277 F. Supp. 2d 622, 644 (E.D. Va. 2003)) (internal quotation marks omitted)), *aff'd sub nom.* SEC v. Wash. Inv. Network, 475 F.3d 392 (D.C. Cir. 2007).

[194] *See, e.g.*, Letter from Ira D. Hammerman, Senior Managing Dir. & Gen. Counsel, Sec. Indus. & Fin. Mkts. Ass'n, to Mary L. Schapiro, SEC Chairman 4 (July 14, 2011), *available at* http://www.sifma.org/issues/item.aspx?id=8589934675 ("SIFMA strongly opposes imposing on broker-dealers the existing Advisers Act standard together with its associated case law, guidance, and other legal precedent.").

[195] *See* SEC 913 STUDY, *supra* note 24, at v.

First, the long-running debate and contradictory case law has failed to clarify the issue.[196] Second, in recent years, brokerage firms have done a tremendous amount of marketing "touting their advisory functions" and blurring "the distinctions between the investment advisory profession and the broker-dealer profession."[197] The continually changing nomenclature of securities professionals has also further muddied the waters. As a 2008 RAND Corporation study noted, typical job titles of employees in brokerage firms include financial advisor, financial consultant, financial representative, and investment specialist, all of which call to mind the duties of an RIA.[198] Lastly, confusion also stems from the fact that unlike in the RIA context, customers do not always know in what capacity a broker-dealer is serving—i.e., as a broker or a dealer—until the transaction is complete.[199]

The divergent standards for RIAs and broker-dealers give rise to a series of questions. Is there any justification for imposing a lesser standard of care on broker-dealers compared to RIAs? If not, should we align the standards? If we should align the standards, should we do so for all customers or draw distinctions based on wealth or size?

Given the uphill climb that wronged investors face in suitability cases, and the fact that this climb is even steeper for large investors, it makes sense to impose a heightened fiduciary standard of duty on broker-dealers equivalent to the one placed on RIAs by the Advisers Act. Notwithstanding the contrary suggestion of a recent SEC staff study on this topic,[200] a uniform fiduciary standard should be in place irrespective of the wealth of the customer and irrespective of whether the firm acted as dealer or broker

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[196] *See supra* notes 188–93 and accompanying text.

[197] Letter from Ron A. Rhoades, Dir. of Research, CCO, Joseph Capital Mgmt., LLC, to SEC Chairman & Commissioners 13 (Mar. 8, 2005), *available at* http://www.sec.gov/rules/proposed/s72599/s72599josephcap.pdf; *see also* Laby, *supra* note 188, at 399–405 ("[C]hanges in . . . the labels [broker-dealers] use for marketing . . . should subject brokers that provide advice to the Advisers Act."). As Laby notes:

> The tidy separation between brokers and advisers began to crumble . . . in the 1980s when brokers started to offer financial planning services, and more significantly in the 1990s when brokerage firms began to use titles [that] . . . encouraged customers to think of the registered [broker-dealer] representative more as an adviser than a stockbroker.

Id. at 404.

[198] ANGELA A. HUNG ET AL., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 74 (2008), *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

[199] *See* Laby, *supra* note 188, at 400 ("Broker-dealers in the United States have always acted as both agent and principal with respect to their customers. A *broker* acts as an agent, executing securities transactions on behalf of a customer, the principal, with another buyer or seller. A *dealer* acts as a principal, buying securities from or selling securities to a customer out of its own account." (footnote omitted)). Frequently, broker-dealers do not notify a customer which role they played on a deal until the transaction is confirmed. 1 NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW AND REGULATION § 1.04, at 1-20 to -23 (4th ed. 2007 & Supp. 2008).

[200] *See supra* note 24 and accompanying text.

on the transaction in question.[201] While the SEC staff study asserts that confusion is only likely with respect to smaller retail customers,[202] the evidence suggests otherwise, given how common it is for large entities like CCM, SDCERA, and P&G to assert breach of fiduciary duty claims against investment firms and hedge funds once transaction value evaporates.[203]

As suggested earlier, the fact that courts and arbitration panels presume large entities to be sophisticated means they are disadvantaged twice. On the front end, the statutory exemptions like those in Regulation D, § 4(5), and Rule 144A based on size or wealth mean institutional investors are not necessarily benefitting from the mandatory disclosures of a registration statement. Instead, they rely on the less fulsome disclosures of a private placement memo, their bargaining power, and their ability to hire advisors. While some commentators argue that this discrepancy does not disadvantage large institutions given their ability to bear the economic risk, the inflation-eroded numerical benchmarks and the lack of graduated caps in these exemptions undermine this argument. Meanwhile, on the back end, the ability of investment firms to employ the sophisticated investor affirmative defense in suitability cases based on a customer's size or wealth, coupled with the prevalence of industry-standard mandatory arbitration clauses, means large entities are disadvantaged when it comes to legal remedies when investment value evaporates.

D. Consideration of Counterarguments

There are numerous potential counterarguments to the above two proposals. First, free market advocates would likely raise the same antipaternalist objections that could be directed at Professor Hazen's proposed overhaul of securities laws modeled on existing insurance industry regulations. A related critique might be that large sophisticated actors require less regulatory protection because the negotiating leverage they possess renders regulation costly overkill that produces a suboptimal level of economic activity.[204] However, a key point overlooked by the antipaternalist advocates concerns the utility of a limited form of

[201] Because investment firms trade as principals in addition to acting as intermediaries, some have argued it would not be feasible to require such firms to put customers first. While an important point, there are potential solutions such as stronger customer warnings or variations on the controversial Volcker Rule restricting proprietary trading. *See, e.g.*, Letter from Ira Hammerman to Mary Schapiro, *supra* note 194, at 10.

[202] *See supra* note 24 and accompanying text.

[203] Although alleging a breach of fiduciary does not necessarily establish a plaintiff's confusion about the standard if the allegation is a cynical legal strategy, the fact that it is a colorable argument in such contexts suggests authorities recognize the potential for confusion here.

[204] *See* ROBERT CHARLES CLARK, CORPORATE LAW 730 (1986).

paternalism where there are severe asymmetries of information between parties of the kind that plague the financial markets.[205]

A more difficult counterargument to answer is one that could be levied against any proposal that increases regulatory burdens in financial markets. Many anti-regulation voices emphasize the degree to which the economy is heavily dependent on the liquidity and investment capital provided by efficiently functioning capital markets. Any proposal that increases the compliance costs or liability exposure of issuers and broker-dealers is open to critique on the grounds that it will threaten the access to capital that fuels economic growth.[206]

In response to concerns about capital formation, the best answer may be found in an amici curiae brief filed by two former SEC Chairs and a former Commissioner. The brief points out that concerns about increased liability exposure deterring firms from doing business in the United States may be misplaced because "in fact, investor faith in the safety and integrity of our markets *is* their strength. The fact that our markets are the safest in the world has helped make them the strongest in the world."[207]

The above statement underlines the fact that the goal is never simply to minimize regulatory burdens or liability exposure to the greatest extent possible. This would be as wrongheaded as seeking to maximize regulatory costs or liability exposure to the greatest extent possible. The sensible goal is to optimize the regulatory costs and burdens on actors in the marketplace. Given the massive losses suffered by large entities that purchased investment products they did not understand, the evidence suggests we are still below an optimal level of financial regulation. In large part, this is the result of regulators' reliance on outmoded, simplistic sophistication proxies coupled with judges' and arbitrators' presumption of sophistication for large entities in contexts where the potential for predatory conduct by investment firms is not cabined by a uniform fiduciary duty standard.

CONCLUSION

Ultimately, the question posed by this Comment's title—should size or wealth equal sophistication in federal securities laws?—must be answered

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[205] *See, e.g.*, Conference Paper, European Summer Symposium in Economic Theory, Alvaro Sandroni & Francesco Squintani, Paternalism in a Behavioral Economy with Asymmetric Information 2 (July 10, 2006), *available at* http://www.cepr.org/meets/wkcn/6/6646/papers/Squintani.pdf ("When agents are fully rational, compulsory public insurance . . . may be a Pareto improvement in markets with asymmetric information.").

[206] *See, e.g.*, Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 732 (1995) ("If there is *excessive* securities litigation, too many resources will be spent on litigation . . . . The cost of capital will then increase just as if a wasteful tax had been imposed on capital formation.").

[207] Mot. for Leave to File Brief out of Time and Brief *Amici Curiae* of Former SEC Commissioners in Support of Petitioner at 9, Stoneridge Inv. Partners, LLC, v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008) (No. 06-43), 2007 WL 2065260, at *9.

with a lawyerly equivocation: it depends. As things stand, there are serious flaws in the approach of federal securities laws to sophistication proxies based on size and wealth. Unless the existing benchmarks are adjusted for inflation on a going-forward basis and graduated caps on unregistered investments as a percentage of investor net worth are introduced, these proxies will continue to diverge from the justifications for exemptions originally expressed in *Ralston Purina*.[208] These justifications—the main argument for the existence of sophistication proxies—are that investors with certain levels of wealth have the ability to "purchase" sophistication, wield bargaining power to extract disclosures, and better tolerate economic risk. The introduction of inflation adjustments and graduated caps on investments as a percentage of net worth will better serve such justifications. Nonetheless, the lack of a clear understanding of the duty owed to customers by broker-dealers suggests large investors will continue to receive less than optimal levels of protection unless a uniform fiduciary duty is imposed on broker-dealers in their dealings with both retail and institutional customers equivalent to the duty imposed on RIAs under the Advisers Act.

[208] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).