We want the sophisticated investor to protect himself, but we also want a system that identifies crooks and comes down like the wrath of God on them. We need both.  

—Charles Munger, vice chairman of Berkshire Hathaway

And here I think what’s intriguing is we have a failure of both.  

—Joseph Grundfest, Stanford Law School professor

The conditions that created the financial crisis of 2008 were enabled by decades of government deregulation justified by the premise that for transactions among sophisticated investors government interference was unnecessary, if not counterproductive. Instead of laws and rules to protect investors and markets, we were told we could rely on savvy counterparties to promote financial stability. Sophisticated investors purportedly had the expertise and incentives to properly assess risk, and to select and monitor complex investment options.

The concept of the sophisticated investor exception is embedded in the federal securities laws. It allows securities issuers to sometimes bypass legal requirements intended to protect ordinary retail investors. The securities laws were designed, initially, to protect such retail investors from confusing, worthless, or high-risk investments. However, many investment options can be offered to sophisticated or accredited investors (collectively “sophisticated investors”) include pension funds, mutual funds, hedge funds, endowments, broker-dealers, insurance firms, banks, and sovereign funds, among others. They also include individuals who earn as little as $200,000 per year.

In retrospect, reliance upon sophisticated investors was misguided. In the lead-up to the 2008 financial crisis, these institutions created instability both for their firms and for the system at large. As detailed in “The Sophisticated Investor and the Global Financial Crisis,” there are numerous examples of sophisticated investors’ failures involving matters central to the credit crunch and financial crisis.

Addressing Sophisticated Investor Shortcomings in the Dodd-Frank Act

There are several provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 that attempt to address the shortcomings of sophisticated investors. One example is that the Dodd-Frank Act seeks to push sophisticated investors to conduct more thorough independent assessments of credit risk, instead of what many perceived as sole reliance on ratings furnished by Nationally Recognized Statistical Rating Organizations (NRSROs or credit rating agencies). Another
example, the Dodd-Frank Act permits the U.S. Securities and Exchange Commission (SEC) to enact a rule requiring sophisticated investor firms (and other issuers) to include candidates nominated by shareholders on the official proxy ballot. On their own, neither of these provisions are likely to improve the performance of sophisticated investors, due to the reasons set out below.

The Dodd-Frank Act tackles the problem of inflated credit ratings somewhat indirectly. It does not end the conflict of interest that lies at the heart of the problem, namely that the issuers of securities select and pay the credit rating agencies to provide the ratings. Instead, the law employs other tactics, including imposing new governance requirements on credit rating agencies, and attempting to create new liability if they give permission for their ratings to be included in public offering documents. In addition to seeking to improve the internal practices and accountability at credit rating agencies, the law also tries to improve the behavior of the sophisticated investors who use ratings when purchasing debt securities. This focus addresses the assumption that sophisticated investors unduly relied on triple-A ratings provided for complex mortgage-linked securities without sufficient independent investigation and analysis. The Dodd-Frank Act mandates that certain references to the credit rating agencies be eliminated where referenced in federal laws. Similarly, it requires federal agencies to remove from regulations references to or reliance on credit rating agencies and substitute instead other measures or standards for creditworthiness.

While this mandate may appear to be a way to alter sophisticated investor behavior, it overlooks two important observations. First, even before the crisis, certain institutional investors were not legally permitted to solely rely on NRSRO ratings. For example, under Rule 2a-7 of the Investment Company Act of 1940, money market mutual funds generally were required to limit their investments to holdings that received high ratings from NRSROs. In addition, however, Rule 2a-7 also required that the money market fund board determine that any security acquired presented “minimal credit risk.” Thus, it was an overstatement to suggest that all institutional investors were legally permitted to blindly rely on these ratings. Indeed, Reserve Primary Fund, the money market fund that “broke the buck” on September 16, 2008, and triggered a massive run on the money market fund industry that week, was subject to the minimal credit risk requirement. Nevertheless, it had $785 billion in short-term (including repo) exposure to Lehman Brothers.

The second observation is that the removal from statutes and regulations of NRSRO credit ratings will not necessarily change the reliance under contractual arrangements. Money managers enter into agreements with large investor clients under which they have used, and many continue to use, these credit ratings as guidelines. Considered together, it is worth exploring how much has or will change for those investors that previously were mandated (by law or by contract) to engage in a minimal credit risk analysis and those investors who continue to rely on NRSRO ratings.
The Dodd-Frank Act also seeks to empower the shareholders of sophisticated investors and other corporate issuers to hold their own executives and directors accountable. It is difficult for shareholders who are dissatisfied with the performance of a CEO to take meaningful action. Shareholders must rely upon the board of directors to discipline or fire a CEO. Correspondingly, if the shareholders seek to pressure their board of directors, there are limited options. Though state corporate law grants shareholders the right to vote for directors, this right is often illusory. The directorial election process involves the ratification of board-nominated candidates; if there are ten seats on the board up for re-election, ten board-nominated candidates will appear on the ballot. Though state law also often gives shareholders the right to nominate candidates, in practice, this is a difficult and costly endeavor. To conduct such a “proxy fight,” the insurgent shareholder would need to pay for a separate mailing to shareholders to present the slate of alternate candidates. Given these obstacles, to facilitate the nomination of directors by shareholders, over the years, the SEC considered allowing long-term, large shareholders to nominate some of their own candidates for election and have them included on the official corporate ballot in the proxy mailing that is sent to shareholders in advance of the annual meeting.15

Section 971 of the Dodd-Frank Act clarifies that the SEC has the statutory authority to issue a rule that provides shareholders access to the proxy to nominate directors for election. In response, the SEC issued Rule 14a-11 (the Proxy Access Rule) that permitted qualified shareholders (those with at least 3 percent of the voting power for 3 years) to request approval by shareholders of a corporate procedure allowing one or more shareholder nominees (for up to 25 percent of total seats) to be included on the official ballot.16 The Business Roundtable and U.S. Chamber of Commerce promptly sued the SEC. A year later the Federal Circuit Court for the D.C. Circuit struck down the Proxy Access Rule.17

Supporters of proxy access contended that this new power to nominate individuals other than management’s “lapdogs” was critical to reining in management excess and ensuring the company performs well, thus, maximizing the long-term value of shares. Supporters have put forward research showing a correlation between firm performance and strong boards. In addition, supporters of proxy access viewed it as a remedy to poor board oversight at failed firms including Enron Corporation, Lehman Brothers and American International Group (AIG). Notably, certain board members of firms that failed miserably during the financial crisis maintain their board positions at those or other firms.

Opponents decried this nomination right, arguing that shareholders with special interest agendas, such as unions and public pension funds would hijack corporate boardrooms and deeply damage the capitalist system. Moreover, they contended that shareholders lacked the requisite skills to select qualified board members.18
The Proxy Access Rule could have helped remove ineffective board members, and thereby perhaps encourage managers of sophisticated investor firms to be more diligent in their research and selection of complex investments. However, given the D.C. Circuit decision, unless the SEC is successful in a future attempt to issue a replacement, this important attempt to address sophisticated investor shortcomings will not be effective.

**Addressing Sophisticated Investor Shortcomings through Enforcement**

Government enforcement actions related to the financial crisis might be an avenue to address sophisticated investor shortcomings. However, most high-profile government enforcement efforts have targeted the sellers of toxic mortgage securities, not the buyers. For example, Goldman Sachs settled with the SEC for $550 million in connection with its sale of tranches of Abacus—a complex synthetic collateralized debt obligation structure. Though the purchasers were apparently sophisticated institutions, including a German and Dutch bank (that lost $1 billion on the deal), they were not as sophisticated as John Paulson, the hedge fund manager who had apparently worked with Goldman Sachs employees to structure the deal so that he could bet against a careful selection of mortgage-backed securities for which the underlying homeowners were very likely to default.\(^\text{19}\)

The SEC prevailed in a civil fraud case against Fabrice Tourre,\(^\text{20}\) the Goldman Sachs banker involved in the Abacus deal, who perfected the art of sophisticated investor arbitrage. Tourre seems to have understood that there were two types of sophisticated investors: those with skills equal to the bankers they were doing business with, and those institutional investors and real people who qualified under the law as “sophisticated” but were quite easy to fool. This can be seen in the “fabulous Fab’s” testimony during hearings before a Senate subcommittee. In his prepared written remarks, from which he read, Tourre defended his role in selling the Abacus bonds. “I was an intermediary between highly sophisticated professional investors—all of which were institutions. None of my clients were individual, retail investors,” he explained. However, during the question-and-answer period of the hearings, Sen. Susan Collins (R-Maine) challenged this assertion, reading from an e-mail that Tourre sent, in which he expressed disappointment with the list of target investors. He wrote: “This list might be a little skewed towards sophisticated hedge funds with which we should not expect to make too much money since (a) most of the time they will be on the same side of the trade as we will, and (b) they know exactly how things work and will not let us work for too much $$$, vs. buy-and-hold rating-based buyers who we should be focused on a lot more to make incremental $$$ next year.”

In the view of Sen. Collins, “This sounds like a deliberate attempt to sell your products to less sophisticated clients who would not understand the products as well so that you can make more money.”\(^\text{21}\)
The government has had limited success, however, bringing cases against buy-side sophisticated investors, for example, arguing that they mislead their own investors or otherwise breached their fiduciary duties. There are notable examples where the government lost cases against the individual decision makers at buy-side firms. These includes the criminal prosecution of Ralph Cioffi and Matthew Tannin, the two Bear Stearns hedge fund managers, and the SEC’s civil suit against Bruce Bent and Bruce Bent II, the father and son who ran the investment advisory firm for the Reserve Primary Fund.

After receiving an internal report concerning trouble with triple-A tranches of subprime-backed collateralized debt obligations in the Bear Stearn-sponsored hedge funds’ portfolios, Tannin sent an email to Cioffi declaring that the “subprime market looks pretty damn ugly” and if the report were accurate, then they should shut down the hedge funds because the “entire subprime market is toast.” But a few days later, they assured investors during a conference call that all was well. Cioffi and Tannin were charged with crimes including conspiracy, wire fraud, and securities fraud. However, a jury acquitted them.\(^{22}\)

The SEC contended that the Bent duo and their management firm “engaged in a systematic campaign to deceive the investing public into believing that the Primary Fund—their flagship money market fund—was safe and secure despite its substantial Lehman holdings.” The complaint alleged the two knowingly disseminated “false information to the Primary Fund’s Board of Trustees, investors, and rating agencies.” A jury found the Bents not liable for fraud, but did find the son negligent. The investment advisory firm and broker-dealer, however were found liable for fraud.\(^{23}\)

**Ongoing Threats to Financial Stability**

Meanwhile, many of the conditions that helped cause the 2008 crisis persist. First, the top six U.S. banks are larger than they were before the crisis. Second, though a proposal to restrict leverage has been suggested, banks (and their holding companies) are legally permitted to borrow $97 for every $100 in assets they own, and private pools of capital, including hedge funds, face no leverage restrictions at all. Third, trillions of dollars are borrowed through the short-term, often overnight, repo market. Fourth, credit derivatives remain insufficiently regulated.\(^{24}\)

Many experts including policymakers, bankers and scholars recognize that the problem of “too big to fail” has not been resolved.\(^{25}\) However, often overlooked in discussions about continued vulnerabilities are the markets in which sophisticated investors still operate without significant government controls. In particular, the continued dependency of large financial firms on overnight and other short-term repurchase (repo) funding to finance their balance sheets has received insufficient attention, despite the fact that it was a run on repo that triggered cascading collapses in 2008. Indeed, the near-demise of Bear Stearns in March 2008 was precipitated by a sudden withdrawal
of repo funding, and led to the unprecedented $30 billion in government support of a “private” rescue by JPMorgan Chase. Similarly, the bankruptcy of Lehman Brothers in September of 2008 came after a withdrawal of repo and other wholesale funding by sophisticated investors. Lehman Brothers had $200 billion outstanding in overnight repo loans before it collapsed. One mutual fund family that had been rolling over $12 billion in overnight repo loans to Lehman Brothers, suddenly demanded its money, tapering down to just $2 billion a week later. Lehman Brother’s failure triggered a run on other aspects of the shadow banking system, including a $300 billion run on the institutional money market funds the week it failed.

These frailties in both the repo and money market funds have not been remedied. At the peak, in spring of 2008, about $2.8 trillion in collateral was posted through the tri-party repo market. Today, Treasury Secretary Jack Lew and others recognize that repos remain a fragile source of funding with roughly $1.8 trillion in collateral financed through the tri-party repo market in July 2013. The tri-party arrangements are only one part of the overall repo market.

Given both the failure of sophisticated investors to either guard their own firm’s financial stability or to prevent systemic risk, it is foolhardy to expect financial reforms that continue to depend upon sophisticated investors either to self-police, police the market, or to provide regulators with enough critical information. Even post-crisis—as demonstrated by the more than $6 billion London Whale trading loss at JPMorgan Chase and the money laundering behavior at HSBC—we have learned that sophisticated investors, can withhold or fail to provide information about their firms because their own employees make mistakes or commit fraud. Moreover, as the jitters regarding raising the U.S. debt ceiling showed, the vulnerabilities and interconnections between the repo markets, money market funds, and broader financial stability continue to be a tinderbox, awaiting another asset reversal or shock to ignite.

Endnotes

1. Gertrude Stein, Everybody’s Autobiography (New York, NY: Random House, Inc., 1937), p. 298 (“what was the use of my having come from Oakland it was not natural to have come from there yes write about it if I like or anything if I like but not there, there is no there there.”)


4. Ibid.,

5. See, Remarks by Chairman Alan Greenspan, the Annual Conference of the Association of Private Enterprise Education, Arlington, Virginia, April 12, 1997 in a 1997: “As we move into a new century, the market-stabilizing private regulatory forces should gradually displace many cumbersome, increasingly ineffective government structures. This is a likely outcome since governments, by their nature, cannot adjust sufficiently quickly to a changing environment, which too often veers in unforeseen directions;” available at http://www.federalreserve.gov/boarddocs/speeches/1997/19970412.htm


7. It’s important to note that while Rule 506, which allows for an exemption to registration requirements, allows sales to an unlimited number of accredited investors, it also allows issuers to sell unregistered securities to a small number of those with don’t qualify as accredited, but who “have enough knowledge and experience in finance and business matters to evaluate the risks and merits of the investment … or be able to bear the investment’s economic risk.” This narrow exception is sometimes referred to as the sophisticated investor exception; however, as a practical matter,
because it is difficult to judge whether an investor has that knowledge and experience, issuers rely on the “accredited investor” definition and other objective definitions that use an objective measure of assets or income. Accordingly, when industry members refer to investors as sophisticated, they are typically referring to the objective measures of wealth, not the subjective question of actual knowledge or skill.


11. Section 971 of Dodd-Frank amended the 1934 Act to provide that the SEC may issue rules permitting the use by a shareholder of proxy solicitation materials supplied by an issuer of securities for the purpose of nominating individuals to membership on the board of directors of the issuer, under such terms and conditions as the Commission determines are in the interests of shareholders and for the protection of investors [and that the SEC may] by rule or order, exempt an issuer or class of issuers from the requirement made by this section or an amendment made by this section;”

12. Paul Krugman, “Berating the Raters,” New York Times, April 26, 2010: “Issuers of debt — which increasingly meant Wall Street firms selling securities they created by slicing and dicing claims on things like subprime mortgages — could choose among several rating agencies. So they could direct their business to whichever agency was most likely to give a favorable verdict, and threaten to pull business from an agency that tried too hard to do its job. It’s all too obvious, in retrospect, how this could have corrupted the process.”


16. Facilitating Shareholder Director Nominations, Securities Act Release No. 9136, Exchange Act Release No. 62,764, Investment Company Act Release No. 29,384 (Aug. 25, 2010) [hereinafter, Proxy Access Rule]; also see SEC Press Release, SEC Adopts New Measures to Facilitate Director Nominations for Shareholders, August 25, 2010, also available at http://www.sec.gov/rules/final/2011/33-9259.pdf; see also Lisa Fairfax, “Proxy Access Forum: The New Proxy Access - Some Initial Thoughts,” The Conglomerate, August 25, 2010: “it also seems noteworthy that while the SEC recognized and took note of state law changes aimed at facilitating proxy access, such as the Delaware and ABA amendments, those changes did not dissuade it from fashioning a federally mandated rule. Under the SEC’s view, even if proxy access bylaw amendments were permissible in every state, the fact that shareholder proposals could face significant obstacles that could undermine shareholder efforts to obtain proxy access warranted a federal rule.”


18. J. Robert Brown Jr., “Staying Access,” The Race to the Bottom, October 6, 2010 (“As we have noted, access is the beginning of a paradigm shift in corporate governance. Opposition to the provision has been powerful and unabated, particularly from the issuer community. The opposition is understandable. It will ultimately contribute to a more shareholder centric approach to governance, altering the way things are done inside the boardroom.”)


23. SEC v. Reserve Management Company, Inc., RESRV Partners Inc., Bruce Bent Sr., and Bruce Bent II (Defendants) and the Reserve Primary Fund (Relief Defendant), Complaint, May 5, 2009; Grant McCool, “Fund Pioneer Bent, Testifying at Trial, Tries to Shift Blame,” Reuters, October 12, 2012; Kirsten Grind and Julie Steinberg, “Reserve Primary’s Managers Cleared in SEC Fraud Case,” Wall Street Journal, November 12, 2012; Nathaniel Popper and Jessica

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