MADOFF PONZI SCHEME EXPOSES "THE MYTH OF THE SOPHISTICATED INVESTOR"

Felicia Smith*

ABSTRACT

On June 29, 2009, Bernard L. Madoff was sentenced to 150 years in a federal penitentiary for his role in a multinational Ponzi scheme of historic proportions—some $64.8 billion (which included estimated gains from apparently bogus investment returns). The criminal charges against Madoff included securities fraud, investment adviser fraud, international and domestic money laundering, and perjury.

Many of Madoff's investors were regarded as sophisticated investors. Since its adoption in 1933, the Securities Act affords an exemption from the registration requirements for issuers who offer securities to sophisticated investors because these investors have the resources and financial expertise to obtain access to, and evaluate, disclosures concerning the offering they deem significant for their respective investment decisions. Thus, the federal statute recognizes that because sophisticated investors "can fend for themselves," they do not require the protections that the registration provisions are designed to provide.

At the very least, sophisticated investors would have been expected to act in their own interests and would have had the means to do so. Then why did so many sophisticated investors—institutional and individual—fall prey to Madoff's fraud? Were these institutions and individuals unable to fend for themselves, or in the face of reports that Madoff strongly discouraged questions, were they simply unwilling to fend for themselves? If sophisticated investors cannot (or will not) fend for themselves, is there any rationale for continuing

* Felicia Smith, Distinguished Visiting Professor of Business Law at Mississippi College School of Law (2008–2010). She holds the LL.M. in Securities Regulation from Georgetown University Law Center, and the J.D. from Mississippi College School of Law. © 2009 and 2010 Felicia Smith. All rights reserved. I acknowledge with profound gratitude a research grant from Mississippi College School of Law. I also acknowledge with gratitude the generosity of my colleagues, Professor J. Gordon Christy and Professor Angela Mae Kupenda, who served as my readers. I also thank Mr. Brian Barnes, Research Librarian, for his assistance, which was invaluable.

to view the private offering transaction as one for which there is "no practical need" for registration or for which "the public benefits are too remote?"

TABLE OF CONTENTS

TABLE OF CONTENTS 217
I.INTRODUCTION 218
II.BACKGROUND 221
A. Madoff Committed "Extraordinarily Evil Crimes" 226
C. Impairment of Investor Confidence in Markets 235
D. Impairment of Investor Confidence in Regulators 240
1. Systemic Failures by the Commission's Staff 240
III. INVESTOR SOPHISTICATION: A PROXY FOR
FEDERAL OVERSIGHT 243
A. Legislative History—An Overview 244
B. Scope of the Private-Offering Exemption 247
C. Accredited Investors 250
D. Policy Considerations 252
IV. THE LIMITS OF THE SOPHISTICATED INVESTOR
OVERSIGHT MODEL 253
A. Diligence by Madoff Investors 254
B. Investors Who Peered Beneath the Surface 260
C. Diligence on Private Offerings 261
D. Factors that Impact Decision-Making 262
E. Accreditation as a Substitute for that "Special
Relationship" 267
F. Many Individual Investors Favored the Status Quo 271
V. LOOKING FORWARD 277
VI.CONCLUSION 282

I. INTRODUCTION

Since 1933, federal law has regulated the offering of securities to the public. The purpose of the Securities Act of 1933[1] (Securities Act) is to "provide full and fair disclosure of the character of securities sold in interstate and foreign commerce . . . and to prevent frauds in the sale" of securities.[2] This is accomplished principally by requiring registration of offerings of securities to the public with the Securities and Exchange Commission (Commission).[3]

Congress also exempted particular securities and specific transactions from the registration régime because it determined that there is "no practical need" for registration or "the public benefits are too remote."[4] One of the transaction exemptions is set forth in Section 4(2) of the Securities Act, which permits an issuer to privately offer its securities to purchasers who are "sophisticated investors."[5] The investors to whom private offerings may be made are considered to be sophisticated investors because they have the resources and financial expertise to obtain access to, and evaluate, information concerning the offering they deem significant for their respective investment decisions and investment objectives.[6] Thus, they are considered to have the wherewithal to "fend for themselves."[7]

In 2009, Bernard L. Madoff (Madoff), a former Chairman of the NASDAQ Stock Market and principal of Bernard L. Madoff Investment Securities, LLC,[8] pled guilty to defrauding investors of an

---

1. Securities Act of 1933, 15 U.S.C. § 77a–aa (2006).
2. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a–aa (2006)).
3. 15 U.S.C. § 77f(a).
4. H.R. REP. NO. 73-85, at 5 (1933) (Conf. Rep.).
5. 15 U.S.C. § 77d(2) (exempting "transactions by an issuer not involving any public offering"). The issuer, however, bears the burden of establishing that the exemption is available for its private offering transaction given the "broadly remedial purposes" of the statute. SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953).
6. *See Ralston Purina Co.*, 346 U.S. at 125–27.
7. *Id.* at 125.
8. Information at ¶ 3, United States v. Madoff, No. 09-cr-213-DC (S.D.N.Y. 2009), *available at* http://www.justice.gov/usao/nys/madoff/20090310criminalinfo.pdf; Transcript of Plea Proceeding at 23, United States v. Madoff, No. 09-cr-213-DC (S.D.N.Y.), *available at* http://www.justice.gov/usao/nys/madoff/madoffhearing031209.pdf (Plea Allocution of Bernard L. Madoff). Madoff formerly was Chairman of London-based Madoff Securities International, Ltd. and a Director of Cohmad Securities Corporation. *Broker Check Report: Bernard Lawrence Madoff*, FINRA, 4, http://www.finra.org/Investors/ToolsCalculators/BrokerCheck (select "START SEARCH"; click box to agree to "Terms and Conditions"; click "CONTINUE"; enter "Bernard Madoff", select "Broker", and click "START

estimated $64.8 billion (an estimate that included gains from apparently bogus "investment returns").[9] Among Madoff's investors were hedge fund managers, charities, pension funds, retirees, celebrities, and self-described "average Americans."[10] Those with the greatest exposure to Madoff had invested amounts ranging from millions to billions of dollars.[11]

As a result of their wealth or expertise in financial or business matters, Madoff's investors would have been considered sophisticated investors.[12] How, then, does one explain the presence of so many sophisticated investors—institutional and individual—

SEARCH"; enter characters in box for BrokerCheck authentication and click "Continue"; click "Bernard Lawrence Madoff (316687)"; click "Get Detailed Report") (last updated Jul. 18, 2010).

9. *Compare* Information, *supra* note 8, at ¶ 14 (noting the total balance of the client accounts managed by Madoff), *with* Plea Allocution of Bernard L. Madoff at 1, 3, United States v. Madoff, 626 F. Supp. 2d 420 (S.D.N.Y. 2009) (No. 09-cr-213-DC), 2009 WL 622150 (Madoff's guilty plea). The Commission had obtained equitable and certain other relief in civil proceedings instituted against Madoff. Madoff Consents to Partial Judgment Imposing Permanent Injunction and Continuing Other Relief, Litigation Release No. 20889, 95 SEC Docket 564 (Feb. 9, 2009), *available at* http://www.sec.gov/litigation/ litreleases/2009/lr20889.htm (showing that Madoff was enjoined from future violations of "Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 there under, and Sections 206(1) and 206(2) of the Investment Advisers Act of 1940"); SEC Obtains Preliminary Injunction, Asset Freeze, and Other Relief Against Defendants, Litigation Release No. 20834, 94 SEC Docket 3091 (Dec. 19, 2008), *available at* http://www.sec.gov/litigation/litreleases/ 2008/lr20834.htm. Subsequently, the Commission announced that on June 16, 2009, it had permanently barred Madoff from the securities industry. *SEC News Digest (Issue 2009-115)*, SEC. & EXCH. COMM'N (June 17, 2009), http://www.sec.gov/news/ digest/2009/dig061709.htm.

10. Transmittal Letter and Exhibits at 32–33, United States v. Madoff, 626 F. Supp. 2d 420 (S.D.N.Y. 2009) (No. 09-cr-213-DC), EFC No. 85 (statement of wife and husband who had invested in a Madoff feeder fund).

11. *See Madoff's Victims*, WALL ST. J. (Mar. 6, 2009), http://s.wsj.net/public/resources/ documents/st_madoff_victims_20081215.html (listing prominent customers and others with large exposures to Madoff's fraud).

12. For purposes of this article, the term sophisticated investors also encompass "accredited investors" within the meaning of rule 501(a) of Regulation D under the Securities Act. 17 C.F.R. § 230.501(a) (2009). Accreditation is a concept the Commission initially created to obviate the uncertainty arising from a requirement that an issuer make a "subjective determination" concerning an offeree or purchaser's sophistication or financial condition. Under former Rule 146, an issuer would determine a particular purchaser's eligibility to participate in an offering by reference to the rule's objective standards for accredited persons. Exemption of Limited Offers and Sales by Qualified Issuers, Securities Act Release No. 6180, 45 Fed. Reg. 6362, 6363 (Jan. 28, 1980) (to be codified at 17 C.F.R. pts. 230 and 239).

among Madoff's clientele? Why did they fall prey to Madoff's fraud? Were these institutions and individuals unable to fend for themselves, or in the face of reports that Madoff strongly discouraged questions, were they simply unwilling to fend for themselves? At the very least, sophisticated investors would have been expected to act in their own interests and would have had the means to do so.

Did the behavior of these sophisticated investors represent the typical diligence in private offerings (even if written policies and procedures established a more formal structure), or was this an aberration—a lapse in discipline by sophisticated investors that is unlikely to be repeated? If sophisticated investors cannot (or will not) fend for themselves, is there any rationale for continuing to view the private offering transaction as one for which there is "no practical need" for registration or for which "the public benefits are too remote"?[13]

Numerous investors, particularly elderly retirees, are now reported to have "lost" everything.[14] The Madoff fraud also has affected persons and communities who rely on philanthropic entities.[15] These entities have shuttered their doors—or have had to curtail significantly their activities—because the funds on which they relied to perform their essential charitable roles in their respective communities have been dissipated.

In light of these developments, policy makers should re-examine the wisdom of continued reliance on the statutory model that leaves *sophisticated investors* to *fend for themselves*.

Part I summarizes the criminal charges to which Madoff pled guilty and the impact of Madoff's fraud on his investors. Madoff's fraud

13. H.R. REP. NO. 73-85, at 5 (1933) (Conf. Rep.).

14. *See, e.g.*, Transmittal Letter and Exhibits, *supra* note 10.

15. *See* Eleanor Laise & Dennis K. Berman, *Impact on Jewish Charities Is Catastrophic*, WALL ST. J., Dec. 16, 2008, at A20, *available at* http://online.wsj.com/article/SB122933474726606471 (noting that Madoff and many of his clients were major contributors to charities); *see also* Mike Spector, *Bear Market for Charities*, WALL ST. J., Jan. 24, 2009, at A1 (financial crisis and Madoff fraud have adverse impact on Harlem Children's Zone's donor base); Andrea James, *Madoff Scandal Felt in State: Area Foundations Among at Least 16 Victims in Region*, SEATTLE POST-INTELLIGENCE (Feb. 5, 2009, 9:10 PM), http://www.seattlepi.com/business/398977_madoffwa06.html (funding for a Seattle-area "social justice project" was imperiled due to reliance on donors who were Madoff investors); Brooke Masters & Joanna Chung, *Big Madoff Investors Targeted*, FIN. TIMES (Feb. 25, 2009, 19:18), http://www.ft.com/cms/s/3b5c320e-0368-11de-b405-000077b07658,dwp_uuid=24032e94 (at least 200 charities are reported to have invested with Madoff); *Weisel Foundation Loses Nearly Everything in Madoff Scheme*, WALL ST. J. (Jan. 23, 2009, 1:04 PM), http://online.wsj.com/article/SB123017956665533701.html ("Many Jewish charities invested with Mr. Madoff, and some have had to close their doors.").

also had an adverse impact on investors' confidence in the markets and in market regulators. Part II presents the legislative history and scope of the private offering exemption, which effectively functions as a proxy for federal oversight of the transaction because the exemption relies on sophisticated investors to fend for themselves in lieu of issuer compliance with federally mandated offering disclosures. Part II also summarizes regulatory initiatives that are designed to provide greater certainty concerning which particular investors would satisfy the eligibility requirements to participate in transactions that rely on the private offering exemption. The limitations of the private offering exemption as illustrated by the Madoff Ponzi scheme are discussed in Part III. Even though the statutory exemption works reasonably well with a discrete class of sophisticated investors, Part IV addresses the policy and regulatory challenges of providing access to privately offered investments to a broad spectrum of individual accredited investors.

II. BACKGROUND

Bernard L. Madoff, who was charged with conducting a multinational, multibillion-dollar Ponzi scheme,[16] pled guilty to an

16. In his statement before the court in March, Madoff testified that he had perpetrated a Ponzi scheme. Plea Allocution of Bernard L. Madoff, *supra* note 8, at 23 ("As I engaged in my fraud, I knew what I was doing was wrong, indeed criminal."). According to the Associated Press, forty Ponzi schemes collapsed in 2008, compared to 150 in 2009. Curt Anderson, *Ponzi Schemes' Collapses Nearly Quadrupled in '09*, LAW.COM (Dec. 29, 2009), http://www.law.com/jsp/law/LawArticleFriendly.jsp?id=1202437299784. The Ponzi scheme is the quintessential application of the proverb "to rob Peter to pay Paul." 3 JOHN WYCLIFE, *The Seven Werkys of Mercy Bodyly*, *in* MISCELLANEOUS WORKS 174 (Thomas Arnold ed., Oxford, Clarendon Press 1871), *available at* http://files.libertyfund.org/files/1474/0743-03_Bk.pdf ("Lord, hou schulde God approve [th]at [th]ou robbe Petur, and gif [th]is robbere to Poule in [th]e name of Crist?"); OXFORD ENGLISH DICTIONARY 101 (2d ed. 1989); JOHN BARTLETT, FAMILIAR QUOTATIONS 160 (Emily Morrison Beck & Little Brown & Co. eds. 15th ed. 1980) (attributed to John Heywood).

The eponymous Ponzi scheme originated as a fraudulent investment program perpetrated by Charles Ponzi, who induced thousands in the 1920s to invest in an arbitrage program in which Ponzi bought depreciated European currencies (*e.g.*, Italian Lire and French Francs), and used the proceeds to buy International Correspondence Reply Coupons issued by the particular European government. Ponzi purportedly derived his investment returns by cashing the Coupons at their par value. *C.W. Barron Skeptical About "Exchange Wizard"*, WALL ST. J., July 30, 1920, at 2, *available at* http://online.wsj.com/public/resources/documents/WSJ-ponzi-07301920.pdf. Ponzi's scheme ultimately relied on infusions of cash from new investors to pay the promised "investment returns" to current investors. Clarence W. Barron had critically noted that "[r]ight under the nose of Government officials [Charles Ponzi] is

eleven-count criminal information,[17] which leveled charges of securities fraud, investment adviser fraud, mail fraud, wire fraud, three counts of international or domestic money laundering, false statements, perjury, false filings with the Commission, and theft from an employee benefit plan against him.[18]

While Madoff acknowledged culpability for his crimes,[19] given the magnitude and breadth of his Ponzi scheme, the possibility that he acted alone seems implausible.[20] Indeed, the Government has

paying United States money to one line of depositors from deposits made by a succeeding line." *Id.* As long as the promoter of a Ponzi scheme can raise sufficient amounts of new investment funds—or limit withdrawals of funds from current investors—the fraud can continue. However, when the promoter can no longer recruit new investors or raise new capital from which to pay out investment returns or make redemptions, the fraudulent nature of the program becomes manifest. *See Finra Investment Alert-Avoiding Investment Scams*, FINRA, at 1, *available at* http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScams/P118010 (last updated Aug. 31, 2009) ("[I]nvestors in a Ponzi scheme typically do not have to recruit new investors to earn a share of 'profits'."); *see also* Stephen Greenspan, *Why We Keep Falling for Financial Scams*, WALL ST. J., Jan. 3, 2009, at W1, *available at* http://online.wsj.com/article/SB123093987596650197.html ("Simply stated, the fact that so many people seem to be making big profits on the investment, and telling others about their good fortune, makes the investment seem safe and too good to pass up.").

17. One consequence of his guilty plea was that any Madoff property that constituted (or may be derived from) the fruits of certain criminal offenses (i.e., securities fraud, mail fraud, wire fraud, money laundering, and theft from an employee benefit plan) was subject to forfeiture to the Government of the United States. Information, *supra* note 8, ¶¶ 42–44. Madoff was remanded into custody after entering his guilty plea. Robert Frank et al., *Madoff Jailed After Admitting Epic Scam*, WALL ST. J., Mar. 13, 2009, at A1. The Commission previously had announced that it had obtained equitable and certain other relief in civil proceedings instituted against Madoff. Litigation Release No. 20889, *supra* note 9 (announcing that Madoff was enjoined from future violations of "Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 thereunder, and Sections 206(1) and 206(2) of the Investment Advisers Act of 1940"); Litigation Release No. 20834, *supra* note 9. Subsequently, the Commission announced that on June 16, 2009, it had permanently barred Madoff from the securities industry. *SEC News Digest (Issue 2009-115)*, *supra* note 9.

18. Information, *supra* note 8. The Government and Madoff did not enter into a plea agreement. Press Release, Dep't of Justice, Bernard L. Madoff Charged in Eleven-Count Criminal Information (Mar. 14, 2009), *available at* http://www.justice.gov/usao/nys/pressreleases/March09/madoffbernardinformationpr.pdf.

19. Plea Allocution of Bernard L. Madoff, *supra* note 8, at 30 ("Your Honor, I hope I have conveyed with some particularity in my own words, the crimes I committed and the means by which I committed them.").

20. Joanna Chung & Brooke Masters, *Fury at Madoff Over Claim He Acted Alone*, FIN. TIMES (London), Mar. 13, 2009, at 16 (noting that because Madoff was not charged with conspiracy, he was not required to identify any co-conspirators.); *The Madoff Affair: Going Down Quietly*, ECONOMIST (Mar. 12, 2009) http://www.economist.com/

continued to investigate the Madoff fraud[21] and to assert its belief that Madoff conducted his fraudulent scheme since at least the early 1980s.[22]

In a collateral development, Mrs. Ruth Madoff, Madoff's wife, agreed to surrender her ownership interest in certain property she owned individually[23] or held jointly with her husband.[24] Prosecutors

---

node/13278976 ("Few believe that he acted alone, but identifying those who colluded, and how, is proving difficult.").

21. *See* Press Release, Dep't of Justice, Bernard Madoff Sentenced to 150 Years in Prison (June 29, 2009), *available at* http://newyork.fbi.gov/dojpressrel/pressrel09/nyfo062909.htm. On August 11, 2009, Frank DiPascali, Jr., a senior manager for the investment advisory business conducted by BLMIS, pled guilty to ten criminal counts for his role in perpetrating the Madoff Ponzi scheme. Transcript of Plea Proceeding at 65, United States v. DiPascali, No. 09-CR-764-(RJS) (S.D.N.Y. Aug. 11, 2009), *available at* http://www.justice.gov/usao/nys/madoff/dipascaliplea81109.pdf; *see also* Information at 1, 33–39, 43, 47, United States v. DiPascali, No. 09-CR-764 (S.D.N.Y. Aug. 11, 2009), *available at* http://www.justice.gov/usao/nys/madoff/20090811 dipascaliinformationsigned.pdf (announcing the criminal information charging DiPascali with ten counts, including conspiracy to commit securities and investment adviser fraud, falsifying the books and records of a registered broker-dealer and a registered investment adviser, and international money laundering). On November 3, 2009, the Government also charged David G. Friehling, BLMIS' auditor, with multiple criminal counts. Information at 1, 9–10, United States v. Friehling, No. 09-Cr.-700-(AKH) (S.D.N.Y. 2009), *available at* http://www.justice.gov/usao/nys/madoff/friehling davids1information.pdf. The Government accepted Friehling's plea agreement. *See* Plea Agreement at 1–6, United States v. Friehling, No. 09-Cr.-700-(AKH) (S.D.N.Y. 2009), *available at* http://www.justice.gov/usao/nys/madoff/friehlingdavidplea agreement.pdf.

22. Government's Sentencing Memorandum at 2, United States v. Madoff, 626 F. Supp. 2d 420 (S.D.N.Y. 2009) No. 09-Cr.-213-(DC), 2009 WL 1899501, *available at* http://www.justice.gov/usao/ nys/madoff/20090626sentencingmemorandumfiled.pdf. The *Wall Street Journal* reported that the "core trading business on which Mr. Madoff built his reputation suffered in recent years as the investment-advisory business . . . grew to be a much bigger part of the company." Aaron Lucchetti, *Madoff's Traders Were In Decline*, WALL ST. J., Jan. 15, 2009, at C1.

23. *See* Amir Efrati, *The Madoff Fraud Case: Assets of Madoff's Wife in Focus*, WALL ST. J., Mar. 3, 2009, at C10, *available at* http://online.wsj.com/article/SB1236050 10820616231.html (reporting that Madoff's Upper East Side apartment in Manhattan, and homes in the Hamptons and Palm Beach, Florida were held solely in Ruth Madoff's name).

24. *See* Press Release, Dep't of Justice, Bernard L. Madoff Ordered to Forfeit Over $170 Billion; Government Settles Claims of Ruth Madoff Against Forfeited Property (June 26, 2009), *available at* http://newyork.fbi.gov/dojpressrel/pressrel09/nyfo062609.htm. Judge Chin's forfeiture order divested Madoff of his interest in real or personal property held individually or jointly. *Id.* Ruth Madoff surrendered her interest in the following property: (1) accounts at Cohmad Securities Corporation and Wachovia Bank, N.A. valued at approximately $59.7 million; (2) the Upper East Side apartment

agreed not to pursue criminal charges against her.[25] Initially, the Madoffs sought to characterize about $70 million of their assets as "untainted" by Madoff's fraud;[26] however, Mrs. Madoff ultimately was allowed to retain about $2.5 million in cash purportedly unrelated to Madoff's fraud.[27]

In a subsequent action, Irving L. Picard (the Securities Investor Protection Corporation (SIPC) Trustee appointed for Bernard L. Madoff Investment Securities, LLC (BLMIS)) alleged that the transfers to Mrs. Madoff—or to entities she controlled or in which she had an interest—were fraudulent conveyances.[28] Seeking to recover approximately $44.8 million for the benefit of Madoff's defrauded investors,[29] Picard explained that his action was driven by "[t]he inequity between Mrs. Madoff's continuing financial advantages and the economic distress of Madoff's customers."[30]

Picard filed lawsuits to "recover $10.1 billion in fictitious profits paid out by BLMIS," the proceeds of which would be used "to satisfy

in Manhattan and homes in the Hamptons and Palm Beach valued at approximately $22.95 million; (3) $1.4 million in proceeds from the sale of the Madoffs' home in Cap d'Antibes, France; (4) furniture, artwork, electronics and appliances, jewelry, apparel, and all other insured or saleable personal property in the Madoffs' residences in New York State, Florida, and France; and (5) "tens of millions of dollars of loans" the Madoffs' made to their family, friends, and employees. *Id.*

25. *See* Amir Efrati, *The Madoff Fraud: Evidence to Charge Ruth Madoff Lacking*, WALL ST. J., July 2, 2009, at C4, *available at* http://online.wsj.com/article/SB1246460 53786080327.html ("Federal investigators have concluded for now there is no physical evidence that Ruth Madoff . . . actively participated in or concealed her husband's fraud.").
26. Efrati, *supra* note 23 at C10; *see also Federal Authorities Seize Madoff's Florida Home, Two Boats in Latest Effort to Claim Assets*, FOXNEWS.COM (Apr. 1, 2009), http://www.foxnews.com/printer_friendly_story/0,3566,512058,00.html (reporting that of the $31.55 million in loans the Madoffs made to their sons Andrew and Mark, approximately $4.5 million of loans were made to Andrew "less than three months before Madoff admitted to [Andrew and Mark] that his investment business was a complete fraud").
27. Press Release, Dep't of Justice, *supra* note 24 (reporting that Mrs. Madoff's assets continue to be subject to the claims of private litigants, or of other governmental entities).
28. *SIPC Trustee Sues Ruth Madoff: Seeks Recapture of $45 Million of Customers' Money She Received from Husband in the Last Six Years,* SEC. INVESTOR PROT. CORP. (July 29, 2009), http://www.sipc.org/media/release29July09.cfm.
29. *Id.* ("Mr. Picard states that 'while Madoff's crimes have left many investors impoverished and some charities decimated, Mrs. Madoff remains a person of substantial means.'").
30. *Id.*

valid BLMIS customer claims."[31] Although Picard decided not to seek recovery of funds distributed to Madoff investors who suffered a net loss from the fraud,[32] certain investors whose distributions from Madoff exceeded their contributions may resist the SIPC Trustee's calls for them to return their Madoff distributions.[33] According to Picard, "Due to the fact that every customer statement was fiction, the first task was to reconstruct the books and records of BLMIS from scratch."[34] Already it is apparent that there were no "profits" in the customers' fictitious account statements, but a number of these investors reportedly want them anyway.[35] In 2010, U.S. Bankruptcy Court Judge Burton Lifland ruled in Picard's favor when he

31. *SIPC: $61 Million in Commitments Made to Madoff Claimants, with $100 Million Level Expected to Be Reached by Memorial Day*, SEC. INVESTOR PROT. CORP. (May 14, 2009), http://www.sipc.org/media/release14May09.cfm.

32. Amir Efrati, *Madoff's Net Losers Safe From Clawbacks*, WALL ST. J., Apr. 24, 2009, at C8.

33. Jane J. Kim, *As 'Clawback' Suits Loom, Some Investors Seek Cover*, WALL ST. J., Mar. 12, 2009, at C3, *available at* http://online.wsj.com/article/SB123681586212702121.html ("[So-called clawback] suits . . . are prompting some investors to protect their remaining assets by transferring them to irrevocable trusts, homes, annuities, or life-insurance policies, according to attorneys."); *SIPC: $61 Million in Commitments Made to Madoff Claimants, with $100 Million Level Expected to Be Reached by Memorial Day*, *supra* note 31 ("Picard added: 'I have a statutory duty to treat fairly all BLMIS customers and part of that duty requires pulling together the largest possible fund of customer property from which to make payments. This includes the duty to investigate, and, where appropriate, go to court to recover from persons or entities who received more than their share. In actual fact, persons who are subject to these recovery efforts actually received money stolen from others. Congress specifically requires that these funds must be returned so that all customers share equally.'"); Associated Press, *'Victims' of Madoff Scandal Do Math, Realize They Profited*, FOXNEWS (Jan. 9, 2009), www.foxnews.com/printer_friendly_story/0,3566,478326,00.html ("The many Bernard Madoff investors who withdrew money from their accounts over the years are now wrestling with an ethical and legal quandary. What they thought were profits were likely money stolen from other clients in what prosecutors are calling the largest Ponzi scheme in history. Now, they are confronting the possibility they may have to pay some of it back.").

34. *See SIPC: $61 Million in Commitments Made to Madoff Claimants, with $100 Million Level Expected to Be Reached by Memorial Day*, *supra* note 31.

35. *See* Jane J. Kim, *Hunt Goes On for Missing Madoff Money*, WALL ST. J., June 29, 2009, at C1, *available at* http://online.wsj.com/article/SB124623268250766291.html ("Even as Mr. Picard gathers up assets, fights are brewing over how much will be paid out. Mr. Picard has said he intends to pay out claims on a 'net equity' basis, or the difference between what customers put in and what they took out . . . . Many former Madoff customers want more. Some said their claims should be based on what was shown on their November 2008 account statements, which reflected balances of nearly $65 billion, before the fraud collapsed.").

confirmed that each investor's respective recovery should not exceed the amounts invested with Madoff, given the "fictitious" nature of the "profits."[36]

A. *Madoff Committed "Extraordinarily Evil Crimes"*

> Here, the message must be sent that Mr. Madoff's crimes were extraordinarily evil, and that this kind of irresponsible manipulation of the system is not merely a bloodless financial crime that takes place just on paper, but that it is instead, as we have heard, one that takes a staggering human toll.[37]
>
> †Judge Chin

With those words, Judge Denny Chin sentenced Madoff to the statutory maximum of 150 years in a federal penitentiary for his role in a multinational, multibillion-dollar Ponzi scheme[38] that defrauded thousands of investors[39] of some $64.8 billion. Indeed, the

36. Sec. Investor Protection Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec, LLC), 424 B.R. 122, 135 (Bankr. S.D.N.Y. 2010) ("The account statements are entirely fictitious, do not reflect actual securities positions that could be liquidated, and therefore cannot be relied upon to determine Net Equity."); *see also* Chad Bray, *Actor Malkovich Wants More from Madoff*, WALL ST. J., Apr. 2, 2010, at C3, *available at* http://online.wsj.com/article/SB100014240527023039606045 75158481004562418.html. Rather than accept Picard's determination that the trust was only entitled to $670,000, the Malkovich trust sought to recover $2.23 million. *Id.*
37. Transcript of Sentencing at 47, United States v. Madoff, No. 09-CR-213-(DC) (S.D.N.Y. June 29, 2009), *available at* http://www.justice.gov/usao/nys/madoff/20090629sentencingtranscriptcorrected.pdf; *see also* Joanna Chung, Brooke Masters, & Alan Rappeport, *Madoff Sentenced to 150 Years in Prison*, FIN. TIMES (June 29, 2009, 19:18), http://www.ft.com/cms/s/0/3c4b9ec2-6496-11de-a13f-00144feabdc0.html.
38. *See* Robert Frank & Amir Efrati, *'Evil' Madoff Gets 150 Years in Epic Fraud*, WALL ST. J., June 30, 2009 at A1. Madoff was also ordered to forfeit $170,799,000,000, which the Department of Justice contended "represents the total proceeds of and property involved in certain of Madoff's crimes." Press Release, Dep't of Justice, *supra* note 21.
39. *See SIPC: $61 Million in Commitments Made to Madoff Claimants, with $100 Million Level Expected to Be Reached by Memorial Day*, *supra* note 31 ("8,848 customer claims have so far been filed in connection with 3,565 customer accounts at BLMIS."). The Government alleged that BLMIS held approximately 4,800 client accounts. *See* Affirmation in Opposition to Madoff's Motion for a Stay and Reinstatement of Bail Pending Sentencing Pursuant to 18 U.S.C. § 3143(a) at 6, United States v. Madoff, No. 09-1025-cr (2d. Cir. Mar. 17, 2009), *available at* http://www.justice.gov/usao/nys/madoff/madoffbailpendingsentencing.pdf.

magnitude of the Madoff fraud dwarfs WorldCom[40] and Enron,[41] "poster children" for corporate fraud of the late 1990s,[42] which the Sarbanes–Oxley Act of 2002[43] sought to correct.

Madoff's attorney sought clemency for Madoff and asserted that a twelve-year prison sentence effectively was "just short . . . of a life sentence," given the statistics available to the defense.[44] Madoff's

40. In *SEC v. Worldcom*, Court Imposes Full Injunctive Relief, Orders Extensive Reviews of Corporate Governance Systems and Internal Accounting Controls, and Orders Training and Education Program to Minimize Future Violations, Litigation Release No. 17866, 2002 WL 31662699 (Nov. 26, 2002), *available at* http://www.sec.gov/litigation/litreleases/lr17866.htm ("WorldCom materially overstated the income it reported on its financial statements by approximately $9 billion.").

41. Enron Corp., Current Report (Form 8-K), at Item 5 (Nov. 8, 2001), *available at* http://sec.gov/Archives/edgar/data/1024401/000095012901503835/h91831e8-k.txt (restating financial statements to, among other things, record a $1.2 billion reduction in shareholders' equity).

42. Two notable examples are Cendant Corporation, which artificially inflated operating income in excess of $500 million from 1995–1997, and Adelphia Communications Corporation, which the Commission alleged "failed to record over $2.3 billion in bank debt by deliberately shifting those liabilities onto the books of Adelphia's off-balance sheet, unconsolidated affiliates." *See* SEC, REPORT PURSUANT TO SECTION 704 OF THE SARBANES–OXLEY ACT OF 2002, at 11, 29 (2003), *available at* http://www.sec.gov/news/studies/sox704report.pdf.

43. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.); *see also Testimony Concerning Implementation of the Sarbanes–Oxley Act of 2002 Before the S. Comm. on Banking, Housing and Urban Affairs*, 108th Cong. 2 (2003) ("The Act also provided welcome new enforcement tools to combat corporate fraud, punish corporate wrongdoers and deter fraud with the threat of stiffer penalties.").

44. Transcript of Sentencing, *supra* note 37, at 34 ("[Madoff] expects . . . to live out his years in prison."). Or maybe the defense believed that Madoff's 12-year sentence request would be more than acceptable because Madoff had (1) "given himself up" rather than have the regulators "discover" his crimes, (2) offered some assistance in obtaining assets that could be used to compensate investors, and (3) not resisted regulators' efforts to close down his business or bar him from the industry; however, this is one instance when it was not "business as usual." The Government, however, discounted the impact of Madoff's cooperation. Government's Sentencing Memorandum, *supra* note 22 at 14 ("Madoff's claim that he deserves credit for 'turning himself in' misses the mark. In fact, Madoff waited to tell his family of his purported plans to turn himself in only when it became clear, and inevitable, that his scheme would collapse, he was almost out of money, and he faced redemption requests that he knew he could not meet. Even then, he took steps that were inconsistent with any real acceptance of responsibility for his acts. For example, he directed the preparation of approximately 100 checks totaling $173 million made out to preferred customers, employees, friends and family, thereby attempting to dissipate investors' remaining assets. Had the FBI not arrested him the next day, he might well have succeeded." (internal citations omitted)).

attorney buttressed his sentencing recommendation with an appeal to the American ideal that justice must be “blind and fair”:

> [N]ot blind to the criminal acts that Mr. Madoff pleaded guilty to and certainly not blind to the suffering of the victims, but blind to the extent that it will achieve a sentence that has been set out over the years in the guidelines and the cases interpreting the guidelines, and the guidelines and the courts and the statutes, your Honor, do not speak of vengeance and revenge.[45]

Judge Chin, however, justified his largely “symbolic” sentence of 150 years for a man with an estimated life expectancy of thirteen years by saying, “The symbolism *is* important because the message must be sent that in a society governed by the rule of law, Mr. Madoff will get what he deserves, and that he will be punished according to his moral culpability.”[46]

Madoff’s investors reportedly were drawn from the United States, Europe, Latin America,[47] and Japan.[48] While Madoff’s initial

45. Transcript of Sentencing, *supra* note 37, at 32.

46. *Id.* at 46–47 (emphasis added); *see also Madoff’s Evil: Moral Clarity on His Crimes, but Who Else Is Guilty?* WALL ST. J., June 30, 2009, at A14, *available at* http://online.wsj.com /article/SB124631773333870809.html (“‘Evil’ is a word that has fallen out of political fashion, suggesting as it does intent or action that is irredeemable. Politicians, especially now, prefer to routinely insinuate vaguely defined moral failure against individuals, corporations and entire industries for opposing an equally vague standard of the public good. No such problem attends Bernard Madoff, who himself yesterday described a personality willing to defraud and debase all who came into contact with him. Madoff’s sentence and Judge Chin’s remarks fit the crime. They are a rare exercise in moral clarity.”).

47. Investors in Latin America may have been more susceptible to Ponzi schemes perpetrated by U.S.-based con artists because of the strength of U.S. dollar-denominated investments, a desire to avoid unstable domestic political environments or “confiscatory tax rates,” and the Ponzi scheme’s façade of “legitimacy and government oversight.” *Latin America: More Ponzi Schemes,* LATIN BUS. CHRON. (Feb. 24, 2009, 12:00 AM), http://www.latinbusinesschronicle.com/app/article.aspx ?id=3159. “The con artists promised safe regulatory oversight, protection against currency devaluation, secrecy (since much of the capital is hiding from authorities), and high returns,” according to a principal of a forensic accounting and consulting firm. *Id.*

48. A list purporting to be BLMIS’ customers, *see Madoff’s Victims, supra* note 11, prepared for the bankruptcy proceedings reportedly was made available to the public. Dionne Searcey & Amir Efrati, *Madoff Clients Exposed*, WALL ST. J., Feb. 6, 2009, at A1, *available at* http://online.wsj.com/article/SB123384533479552435.html. However, Judge Chin refused a request by ABC, Inc., NBC Universal, Inc., and Fox News Network, LLC to make public email communications sent by BLMIS customers to the Department of Justice that described the impact of Madoff’s fraud on these

investors reportedly were New York- and Palm Beach-based Jewish charities and communities, Madoff subsequently was able to attract investments from feeder funds whose clients were European and Latin American investors.[49] Although Madoff's Ponzi scheme was a multinational fraud, the manner in which he dealt with charitable foundations and members of the Jewish community had the attributes of affinity fraud because of Madoff's unique relationship of "trust and friendship" with these investors.[50] Madoff's betrayals of his

customers. United States v. Madoff, 626 F. Supp. 2d 420, 428 (S.D.N.Y. 2009). Some customers had objected to the release of the email communications for a number of reasons, including considerations of "security" for family members. *Id.* at 426–27 (concluding that the "countervailing privacy interests of the victims who oppose the unsealing of their emails is significant," Judge Chin noted that only information that would identify particular persons had been redacted because "the 'victims' privacy interests are significant, [and] the presumption of access to the emails is outweighed.") Given confiscatory tax regimes, and concerns for personal safety, it is not uncommon that investors from certain Latin American jurisdictions prefer not to disclose their identities. José De Córdoba et al., *Latins Quiet About Madoff Losses*, WALL ST. J., Dec. 29, 2008, at C1, *available at* http://online.wsj.com/article/SB123051003837638329.html; Ed Stoddard, *Stanford Latam Clients Don't Want Names Known*, REUTERS.COM (Mar. 11, 2009, 10:00 AM), http://www.reuters.com/articlePrint?articleID=USTRE52A3R120090311 ("In much of Latin America, public knowledge that a person is wealthy or has money for investment purposes can make that person or his family targets for kidnappers."); *see also* José De Córdoba & Thomas Catan, *The Charming Mr. Piedrahita Finds Himself Caught in the Madoff Storm*, WALL ST. J., Mar. 31, 2009, at A1, *available at* http://online.wsj.com/article/SB123845782470271683.html ("Analysts say Mr. Piedrahita . . . played a key role in expanding the reach of the Madoff fraud by wooing wealthy Latin Americans and Europeans to invest in Fairfield Greenwich, which had about half its assets with Mr. Madoff."); David Gauthier–Villars, *Financier's Own Fortune Led Investors to Madoff*, WALL ST. J., Dec. 29, 2008, at C1, *available at* http://online.wsj.com/article/SB123051012836438335.html ("[His] story underscores how Mr. Madoff's success world-wide relied on a network of feeders who trusted the New York fund manager so much they put their whole fortunes in his care."); Zachery Kouwe, *The Brazilian Connection in the Madoff Scandal*, DEALBOOK BLOG (Dec. 16, 2008, 1:18 PM), http://dealbook.blogs.nytimes.com/2008/12/16/the-brazilian-connection-in-the-madoff-scandal ("The fraud appears to span the globe, with investors from South America, Europe and Japan all having invested with Mr. Madoff.").

49. Brooke Masters, *Madoff: Off the Fairway*, FIN. TIMES (Jan. 26, 2009, 20:44), http://www.ft.com/cms/s/628a2dba-ebdd-11dd-8838-0000779fd2ac,dwp_uuid=3d10 0e8 ("While most financial frauds are confined to individual social groups or neighborhoods, Mr. Madoff stands accused of running the world's first truly global Ponzi scheme . . . . [B]y the mid-2000s, so-called feeder funds that supplied Madoff were tapping deep—and not so deep—pockets all over Europe and Latin America.").

50. SEC, OFFICE OF INVESTOR EDUC. & ADVOCACY, AFFINITY FRAUD: HOW TO AVOID INVESTMENT SCAMS THAT TARGET GROUPS 1 (2009), *available at*

friends, charities, and those who had entrusted their entire savings to him were described as "epic in their scope and dazzling in their utter lack of remorse or responsibility."[51]

The private-offering exemption was intended to enable issuers to negotiate with sophisticated investors the conditions under which capital commitments would be made.[52] However, this exemption is not a license for issuers to defraud investors—even if those investors are sophisticated.[53] In any event, the failure of so many sophisticated investors (or their professional advisors) to exercise diligence on their behalf, however, suggests that a fundamental premise for the private-offering exemption may not be valid, if sophisticated investors lack access to material information[54] about the proposed investment.

---

http://www.sec.gov/investor/pubs/affinity.pdf ("Affinity fraud refers to investment scams that prey upon members of identifiable groups, such as religious or ethnic communities, the elderly, or professional groups . . . . These scams exploit the trust and friendship that exist in groups of people who have something in common."); Lisa M. Fairfax, *The Thin Line Between Love and Hate: Why Affinity-Based Securities and Investment Fraud Constitutes a Hate Crime*, 36 U.C. DAVIS L. REV. 1073, 1142 (2003) ("Perpetrators of such fraud exhibit more blameworthy conduct because, as members of the targeted group, they understand the harmful impact of bias-inspired crimes and commit their acts in the face of that understanding."); Lisa M. Fairfax, "*With Friends Like These . . ."; Toward a More Efficacious Response to Affinity-Based Securities and Investment Fraud*, 36 GA. L. REV. 63, 65 (2001) ("This reliance on group trust and sense of community persuades otherwise cautious people to participate in many fraudulent investment schemes."); Transcript of Sentencing, *supra* note 37, at 20 ("[Madoff] betray[ed] . . . the virtues people hold dearest—love, friendship, trust—and all so he can eat at the finest restaurants, stay at the most luxurious resorts, and travel on yachts and private jets."); *see also* Stephen Greenspan, *Why We Keep Falling for Financial Scams*, WALL ST. J., Jan. 3, 2009, at W1, *available at* http://online.wsj.com/article/SB123093987596650197.html (noting that like Madoff, most of the investors who were introduced to Madoff through their country club membership and BLMIS sales representatives were Jewish).

51. Marc Gellman, *A Letter to Madoff*, NEWSWEEK (Dec. 23, 2008), http://www.newsweek.com/id/176821 ("An entire world economy we now know is based to an immense degree on simple trust, and you have done more than any single person to destroy that trust.").

52. *See* H.R. REP. NO. 73-85, at 15–16 (1933) (Conf. Rep.) (providing an exemption to "permit an issuer to make a specific or isolated sale of its securities to a particular person").

53. *See* The Securities Act of 1933, 15 U.S.C. §§ 77q, 78j(b) (2006); 17 C.F.R. § 240.10b-5 (2010).

54. Whether particular information is material requires an examination of the facts and circumstances. Information would be material if there were a substantial likelihood that a reasonable investor would consider it significant in determining whether to purchase the offered securities. 17 C.F.R. § 230.405 (2010); TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976) ("There must be a substantial likelihood that the

Several key indicators highlight the limitations of the current sophisticated investor standard. Madoff's unparalleled fraud caused incalculable damage to investor confidence in U.S. capital markets and profound financial ruin of numerous investors, particularly elderly retirees, who were reported to have "lost" everything. The apparent suicides of a retired military officer[55] and a professional investment manager were reportedly linked to Madoff's fraud.[56] Lastly, Madoff's Ponzi scheme affected persons and communities who rely on philanthropic entities[57] because those entities have shuttered their doors—or have had to curtail significantly their activities—because the funds on which they relied to perform their essential charitable roles in their respective communities have been dissipated as a result of Madoff's fraud. Madoff's tragic, historic, and unprecedented investment duplicity and the resulting consequential fallout strongly evinces that policy makers should reexamine the wisdom of continued reliance on the statutory model of *sophisticated investors* being left to *fend for themselves*.

disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.").

55. Allan Little, *'Banking Crisis Killed My Father'*, BBC NEWS (Feb. 12, 2009, 18:42), http://newsvote.bbc.co.uk/mpapps/pagetools/print/news.bbc.co.uk/2/hi/uk_news/7886894.stm?ad=1 (reporting that he told his son "he had lost all the family money—his entire life savings, close probably to £1m").

56. Gauthier–Villars, *supra* note 48, at C1 (stating that the financier reportedly invested $50 million of personal funds with Madoff); Alan Katz, *Madoff Investor's Suicide Was an "Act of Honor," Brother Says*, BLOOMBERG (Jan. 2, 2009, 18:01), http://www.bloomberg.com/apps/news?pid=20601087&sid=aZ1dnq3VwwOs&refer=home# (reporting that the financier who had "entrusted his entire fortune to Madoff" died in an apparent suicide).

57. Masters & Chung, *supra* note 15 (stating that at least 200 charities are reported to have invested with Madoff); *Weisel Foundation Loses Nearly Everything in Madoff Scheme*, *supra* note 15 ("Many Jewish charities invested with Mr. Madoff, and some have had to close their doors."); *see also* James, *supra* note 15 (explaining that funding for a Seattle-area "social justice project" was imperiled due to reliance on donors who were Madoff investors).

DO NOT DELETE 1/19/2011 6:25 PM

B. *Madoff's Investors: Prominent Persons and "Average Americans"*

> We invested $475,000 with him . . . only to discover that . . . . [m]oney that took us 40 years to accumulate [was] lost in a matter of seconds . . . . You see we are the average Americans . . . . Not every victim is a millionaire or billionaire[,] some of us were just hard working people. . . .[58]
>
> †Madoff Feeder Fund Investors

Madoff's investors were diverse: retirees, prominent figures in the entertainment and business communities, foundations and charities, pension funds, hedge funds, and hedge fund managers.[59] Several institutions reportedly invested billions with Madoff.[60] At the time of

---

58. Transmittal Letter and Exhibits, *supra* note 10, at 32 (quoting a wife and husband who had invested in a Madoff feeder fund).

59. Searcey & Efrati, *supra* note 48 at A1 ("An eclectic list purporting to name thousands of people who lost money in Mr. Madoff's alleged $50 billion scheme . . . includes housewives and retirees, a plumbers union and a high school."); Randall Smith, *Ex-Merrill Executives Got Burned by Madoff*, WALL ST. J., Jan. 30, 2009, at C1, *available at* http://online.wsj.com/article/ SB123327579767931341; Jenny Strasburg, '*Dr. Doom' Didn't Predict Madoff Blowup*, WALL ST. J., Dec. 31, 2008, at C1, *available at* http://online.wsj.com/article/SB123068163425344045.html; Tomio Geron, *Founding Father of VC Linked to Madoff*, WALL ST. J. BLOG (Feb. 5, 2009, 6:12 PM), http://blogs.wsj.com/venturecapital/2009/02/05/founding-father-of-vc-linked-to-madoff; Kouwe, *supra* note 48 ("Wealthy Brazilian investors had combined exposure of $1 billion to $2 billion in the hedge fund manager Fairfield Greenwich Group, the biggest known loser in Bernard L. Madoff's reputed $50 billion Ponzi scheme."); Laura Kreutzer, *A Few PE Professionals Are On Madoff List*, WALL ST. J. BLOG (Feb. 5, 2009, 5:06 PM), http://blogs.wsj.com/privateequity/2009/02/05/a-few-pe-professionals-are-on-madoff-list/; *Madoff's Victims*, *supra* note 11 (providing a list of prominent customers and those with large exposures to Madoff's fraud, which reportedly includes Union Bancaire Privee ($700 million); Yeshiva University ($14.5 million); The Elie Weisel Foundation for Humanity ($15.2 million); Hadassah ($90 million); and New York University ($24 million)); *Report: World's Richest Woman Fell Victim to Madoff Scheme*, TIMES (London), Dec. 24, 2008, *available at* http://www.foxnews.com/story/0,2933,472584,00.html; Vernon Silver & David Glovin, *Madoff Scandal Ensnares Order of Patron Saint for Moralists*, BLOOMBERG (Feb. 13, 2009), http://www.bloomberg.com/apps/news?pid=20670001&sid=apNDOtibG3HA (stating that Madoff's customers included the Congregation of the Most Holy Redeemer).

60. *Dumb Money and Dull Diligence: Like Mould, Madoffs Flourish in the Darkness*, ECONOMIST (Dec. 18, 2008), http://www.economist.com/node/12817637/ ("Tragicomically, a handful of global banks that had fared well during the financial meltdown of the past 18 months are on the list of those caught out. HSBC, a British

their respective investments with Madoff, these purchasers likely would have qualified as sophisticated investors because they were wealthy,[61] and individually (or with assistance from their respective legal or business advisors) they had expertise in financial matters.[62]

Some Madoff investors were not among the "super wealthy" but had comparably modest means.[63] These investors presumably satisfied the minimum dollar threshold for accredited investors as a result of a lifetime of saving and investing, inheritance, or sale of a

bank, Santander of Spain, and BNP Paribas of France: all bear a share of losses that add up to $33 billion, according to a Bloomberg tally. So were the suave private bankers of Switzerland and Singapore."); *Madoff's Victims*, *supra* note 11 (showing institutions reported to have invested at least a billion dollars include Fairfield Greenwich Advisers ($7.5 billion), Tremont Group Holdings ($3.3 billion), Banco Santander ($2.87 billion), Bank Medici ($2.1 billion), Ascot Partners ($1.8 billion), Access International Advisers ($1.5 billion), Fortis ($1.35 billion), and HSBC ($1 billion)).

61. One measure of wealth is net worth (individually or jointly with one's spouse) in excess of one million dollars, which is the standard for a natural person to qualify as an accredited investor within the meaning of rule 501(a)(5) of Regulation D. 17 C.F.R. § 230.501(a)(5) (2010). Another financial measure of wealth is based on an investor's annual income. For example, an individual whose income exceeds $200,000 (or $300,000, jointly with one's spouse) in each of the two most recent years who reasonably expects a similar income in the current year also would qualify as an accredited investor. 17 C.F.R. § 230.501(a)(6) (2010). In the years preceding the 1929 Stock Market Crash, being a millionaire was described as "the standard benchmark for being rich." However, millionaire status seemed diminished with the creation of "a vast new crop of millionaires" in the latter half of the decade, so that by 1929, one million dollars no longer qualified one as "really rich," according to Samuel Crowther. LARRY SAMUEL, RICH: THE RISE AND FALL OF AMERICAN WEALTH CULTURE 42–43 (2009). In 2008, one million dollars would be worth approximately $139,395,752.90, using the relative share of Gross Domestic Product as the basis for calculation. *Six Ways to Compute the Relative Value of a U.S. Dollar Amount, 1774 to Present*, MEASURINGWORTH, http://www.measuringworth.com/calculators/uscompare3 (last visited Jan. 6, 2011) (explaining that the share of Gross Domestic Product is a means of measuring the "economic power" of particular individuals who lived in different eras by comparing the size of their wealth to the economy in which they lived). By contrast, the threshold for entry on the Forbes 400, a compilation of the 400 richest Americans, was a net worth of $1.3 billion in 2008. *The Forbes 400*, FORBES (Sept. 17, 2008, 6:00 PM), http://www.forbes.com/2008/09/16/forbes-400-billionaires-lists-400list08_ cx_mn_0917richamericans_land.html (stating that although 19% of those profiled inherited wealth, two-thirds were self-made).

62. 17 C.F.R. §§ 230.501(h), 506(b)(2)(ii) (2009).

63. *See* Transmittal Letter and Exhibits, *supra* note 10.

family business.[64] It was reported, however, that Madoff's investors also included "hundreds of ordinary retail investors."[65]

The "victim impact statements" filed with the court described the devastating impact of Madoff's Ponzi scheme on many investors.[66] Judge Chin received "several hundred" written statements from Madoff's investors and granted nine investors' requests to speak at Madoff's sentencing hearing.[67] They described to Judge Chin the adverse impact of the fraud on their lives, including the loss of financial security because key pension-distribution and health-insurance decisions were based on their "savings and security with Madoff."[68] For example, Madoff's fraud deprived a widow of her ability to care for herself, meet important societal needs through charitable donations, and support the educational needs of future generations of her family.[69] These investors urged Judge Chin to sentence Madoff to the fullest extent of the law.[70]

Many individuals described feelings of depression, angst, shame, or humiliation at a newfound penury that required them to rely on social-welfare programs.[71] One couple described their experience

64. *Id.*

65. Masters, supra note 49 ("Performance records of European funds that sent money to Mr. Madoff were meanwhile attracting attention—and money—from hundreds of ordinary retail investors.").

66. *See* Transmittal Letter and Exhibits, *supra* note 10 (correspondence from Madoff Victims Submitted to the U.S. Attorney's Office); *see also 113 Madoff Victims Tell Their Stories*, WALL ST. J., June 16, 2009, at C3, *available at* http://online.wsj.com/article/SB124511290745717267.html.

67. Transcript of Sentencing, *supra* note 37, at 4. Since two investors from the same family wanted to address the court, Judge Chin directed that one person could speak on behalf of the family. Two investors withdrew their request to address the court. *Id.*

68. *Id.* at 5–7 (statement of a retired New York City Correction Officer).

69. *Id.* at 9 (statement of a sixty-one-year-old widow).

70. *See id.* at 47; *see also* Annelena Lobb, *For Victims, Downsized Lives and Many Shattered Dreams*, WALL ST. J., June 29, 2009, at C1, *available at* http://online.wsj.com/article/SB124623313963566369.html ("Some elderly victims are going back to work for the first time in decades, taking minimum-wage jobs.").

71. Transcript of Sentencing, *supra* note 37, at 12. A sixty-three-year-old couple who had returned to work stated "[w]e can only work as long as our health will hold up and then we will have to sell our home and hope to survive on social security alone." *Id.* A physical therapist and her husband invested their "entire life savings with Madoff." *Id.* at 14–15. When the physical therapist spoke about her mother, who was also a Madoff investor, she claimed "[n]ow all she has to live on is a sparce [sic] social security check and a small pension which will last less than one year." *Id.* One sixty-five-year-old New York City native claims she "manage[s] on food stamps. At the end of the month I sometimes scavage [sic] in dumpsters. I cannot afford new

since Madoff's exposure as "a living hell. It feels like a nightmare that we can't wake from."[72] The written statements filed by several Madoff investors—many newly impoverished—chronicled hardships engendered by their new statuses. For example, elderly couples were robbed of their sense of dignity, financial independence, and tranquility, and now must rely on whatever resources are available from their children and on social-welfare programs to sustain themselves.[73] Other investors described the unfathomable situation of a lifetime of savings—the product of prudent and fiscally conservative life choices—that dissipated into thin air.[74] A few investors identified themselves as personal acquaintances of the Madoff family and expressed indignation at Madoff's fraudulent conduct.[75]

Moreover, other investors were frustrated by a lack of government financial support for their plight comparable to the "rescues" that were made available to industry segments such as financial firms, Fannie Mae, Freddie Mac, and automakers; instead, they "have found surprising hostility to their predicament."[76]

C. *Impairment of Investor Confidence in Markets*

As we have observed since the onset of what has been called a global credit[77] crisis, trust is an integral component of vibrant capital

---

eyeglasses. I long to go to a concert, but I never do. Sometimes, my heartbeats [sic] erratically for lack of medication when I cannot pay for it." *Id.* at 22–23.

72. *Id.* at 15.

73. *See* Transmittal Letter and Exhibits, *supra* note 10, at 20 (including a letter to the judge from a seventy–six–year-old husband who invested an IRA with Madoff).

74. Transcript of Sentencing, *supra* note 37, at 9–10, 12, 14–15, 17, 21, 25.

75. *See* Transmittal Letter and Exhibits, *supra* note 10, at 45 ("We are outraged by this crime and sick at heart at the callousness of the perpetrator."); *id.* ("We also knew Bernie and Ruth Madoff personally for over 40 years . . . . I would like the chance to speak and let Bernie know that our spirit will still live on even though financially we have been destroyed."); Lobb, *supra* note 70, at C1 ("For many victims, downsizing their lives has been jarring partly because of the illusion of steady returns that Mr. Madoff created, month after month, in account statements filled with blue chips such as Procter & Gamble Co. and AT&T Inc. Mr. Madoff actually bought no securities, so the dividends and sale proceeds tallied up should have been zeroes.").

76. Dionne Searcey, *Post-Madoff, a Support Network*, WALL ST. J., Feb. 2, 2009, at C3, *available at* http://online.wsj.com/article/SB123353195044337435.html (reporting that a couple who lost "the bulk of their life savings" of $1.1 million wrote "I know you are as frustrated as I am that our government has been silent to date on providing any assistance or advice to the victims").

77. Indeed, the origin of *credit* is the Latin word *creditum*, which is derived from *credere*, "to believe," "to trust." OXFORD ENGLISH DICTIONARY 1138 (2d ed. 1989).

markets.[78] According to Paul Seabright, an economist at the University of Toulouse in France,

> trust in a modern economy has evolved to the miraculous point where people give complete strangers sums of money they would not dream of entrusting to their next-door neighbours [sic]. From that a further miracle follows, for trust is what raises the billions of dollars that fund modern industry.[79]

The failures of large financial institutions—such as insurers, commercial banks, and securities broker-dealers—precipitated a crisis of confidence in the ability of financial institutions to honor their commitments.[80] The Dow Jones Industrial Average dropped from 12,474.52 on January 3, 2007, to 8,776.39 by the end of 2008.[81] Governmental authorities around the world responded, in part, by implementing "rescue plans"—or "bailouts"—of financial institutions deemed fundamental to their economies.[82]

---

78. *See* POPE BENEDICT XVI, CARITAS IN VERITATE ¶ 35 (2009), *available at* http://www.vatican.va/holy_father/benedict_xvi/encyclicals/documents/hf_ben-xvi_enc_20090629_caritas-in-veritate_en.html ("In a climate of mutual trust, the *market* is the economic institution that permits encounter between persons, inasmuch as they are economic subjects who make use of contracts to regulate their relations as they exchange goods and services of equivalent value between them, in order to satisfy their needs and desires . . . . *Without internal forms of solidarity and mutual trust, the market cannot completely fulfil* [sic] *its proper economic function.* And today it is this trust which has ceased to exist, and the loss of trust is a grave loss.").
79. Edward Carr, *Greed—and Fear*, ECONOMIST, Jan. 24, 2009, at 3, *available at* http://www.economist.com/specialreports/PrinterFriendly.cfm?story_id=12957709.
80. *See* Charles L. Evans, President & CEO, Fed. Reserve Bank of Chi., Remarks at the Czech National Bank: Central Banking in Times of Crisis (Mar. 24, 2009), http://www.chicagofed.org/webpages/publications/speeches/2009/03.24_CR_speech.cfm ("Because of balance-sheet capacity limitations, or because of higher-than-normal uncertainty and risk aversion, market participants are largely avoiding markets that are undergoing unusual stress."); *see also infra* notes 95, 98.
81. *Dow Jones Industrial Average*, WALL ST. J., Jan. 2, 2009, at R6 (listing reported averages at the close of market); *cf.* SEC, DRAFT-STRATEGIC PLAN FOR FISCAL YEARS 2010–2015, at 5 (2009), *available at* http://www.sec.gov/about/secstratplan1015.pdf ("Between June 2007 and November 2008, Americans lost more than a quarter of their net worth. By early November 2008, the value of retirement, savings, and investment assets suffered dramatic losses, and housing prices had dropped 20 percent from their 2006 peak.").
82. *Asian Nations Unveil $120 Billion Liquidity Fund*, WALL ST. J., May 4, 2009, at A10; Luca di Leo & Christopher Emsden, *Italy Is Ready to Commit Funds to Banking Sector*, WALL ST. J. EUR., Oct. 30, 2008, *available at* http://online.wsj.com/article/SB122532681747882483.html; James Glynn & Rachel Pannett, *In Australia, New Measures Add Liquidity*, WALL ST. J., Oct. 13, 2008, at A5; Marcus Walker et al.,

Investors in hedge funds reportedly have redeemed substantial amounts of capital from these investment vehicles. In October 2008, hedge funds experienced their worst month of withdrawals.[83] In some instances, funds have been shuttered in the face of extreme levels of withdrawals by investors.[84] Some institutional investors pressed hedge funds for more favorable investment terms.[85]

A number of Madoff investors responded by initiating claims against persons they held responsible for Madoff's fraud, including certain financial institutions that provided administrative services to Madoff's business[86] and the Commission.[87] In the case of Fairfield Greenwich Group, one of the largest feeder funds invested with Madoff, Massachusetts regulators alleged that the fund breached its fiduciary duty to its investors when it "[failed] to provide promised due diligence" on the fund's investments in Madoff's program.[88]

Europe Races to Shore Up Banks as Crisis Spreads, WALL ST. J., Oct. 6, 2008, at A1; Hiroko Tabuchi, *Japan Unveils $51.5 Billion Stimulus*, WALL ST. J., Oct. 31, 2008, at A9.

83. Kevin Kingsbury, *Last Month, $40 Billion Pulled from Hedge Funds*, WALL ST. J., Nov. 21, 2008, at C8; *cf*. Cassell Bryan-Low, *Another Wave of Withdrawals Expected to Hit Hedge Funds*, WALL ST. J., Mar. 2, 2009, at C1 (reporting that Morgan Stanley analysts estimated a decline in assets under management of 30% for 2009, in addition to the 20% decline for the last six months of 2008).

84. Jenny Strasburg, Gregory Zuckerman & Cassell Bryan-Low, *Crisis on Wall Street: More Hedge Funds Expected to Succumb*, WALL ST. J., Nov. 22, 2008, at B2 ("Some have curtailed their selling of securities in recent days even amid a torrent of withdrawal requests.").

85. *See* Jenny Strasburg & Craig Karmin, *Calpers Tells Hedge Funds to Fix Terms—or Else*, WALL ST. J., Mar. 28, 2009, at B1, *available at* http://online.wsj.com/article/SB123818466240759815.html (reporting that like some other institutional investors, Calpers wants its hedge funds managers to offer a more favorable performance fee structure, give Calpers the ability to "recoup fees from previous profitable years after a period of poor performance," and disclose securities held in the fund's portfolio).

86. *See* Robin Sidel, *Aggrieved Investors Turn Sights to Banks*, WALL ST. J., Feb. 3, 2009, at C1, *available at* http://online.wsj.com/article/SB123362103067641611.html ("Some [Madoff] investors . . . contend that financial institutions handling money for [Madoff's] firm should have known about the alleged fraud.").

87. Kara Scanell, *Two Investors Sue SEC Over Madoff Probe*, WALL ST. J., Oct. 15, 2009, at A19 (reporting that a retired office worker and doctor seek to hold the Commission accountable for its role).

88. Ashby Jones, *Mass. Sues Madoff Feeder-Fund Fairfield Greenwich, Alleging Fraud*, WSJ BLOGS (Apr. 1, 2009, 10:37 AM), http://blogs.wsj.com/law/2009/04/01/mass-sues-madoff-feeder-fund-fairfield-greenwich-alleging-fraud/; *see also* Robert Frank & Tom Lauricella, *Madoff Feeder Is Charged in Fraud*, WALL ST. J., Apr. 2, 2009, at C1, *available at* http://online.wsj.com/article/SB123859307450378115.html; Karen Freifeld & Katherine Burton, *Massachusetts Accuses Fairfield Greenwich of Fraud*, BLOOMBERG (Apr. 1, 2009, 15:09), http://www.bloomberg.com/apps/news?

New York authorities subsequently sued J. Ezra Merkin, former GMAC Chairman and philanthropist, alleging that he was not an "investing guru," as he had represented, "but a master marketer."[89]

While Celfin Capital of Chile reportedly made full repayment to its clients,[90] Safra Banking Group,[91] Banco Santander,[92] and Union Bancaire Privée[93] reportedly offered to cover some losses sustained by their clients who were Madoff investors. When one considers the fees that certain asset managers, like Luxalpha, reportedly charged clients for their professional expertise, it could hardly inspire investor confidence in asset managers when it became widely known that the actual investment decisions had been handed off to Madoff.[94]

2008 was a tumultuous year filled with constant challenges for investors: J.P. Morgan Chase purchased the distressed Bear Stearns, the federal government rescued Fannie Mae and Freddie Mac, Lehman Brothers melted down, Bank of America acquired a

---

pid=newsarchive&sid=aEFaKZ0Giedw (quoting Secretary of State William F. Galvin: "The allegations against Fairfield in this complaint outline a total disregard for such responsibility, which helped the Madoff scheme stay afloat for so long."). *But see* Tom Lauricella, *Fairfield Greenwich Says Madoff Provided Bad Data*, WALL ST. J., Mar. 2, 2009, at C2 (asserting that Madoff's fraud impeded Fairfield Greenwich's ability to conduct diligence); *Fairfield Greenwich Group Rejects Massachusetts Accusations*, Apr. 29, 2009, *available at* https://www.fggus.com/guest/notice2.html.

89. Liz Rappaport, *Financier Charged in Madoff Fraud*, WALL ST. J., Apr. 7, 2009, at A1, *available at* http://online.wsj.com/article/SB123903070566093099.html (reporting that Merkin placed $2.4 billion of investors' funds with Madoff); *see also Follow the Feeders*, ECONOMIST, Jan. 3, 2009, at 55, *available at* http://www.economist.com/finance/PrinterFriendly.cfm?story_id=12855455 ("New York Law School contends it would never have invested $3m with Ascot Partners had it known that the fund was charging hefty fees merely to stick all its eggs in one basket."). It is estimated that feeder funds were paid $790 million in management and other fees in respect of funds directed to Madoff. Tom Lauricella, *Feeder Fees Topped $790 Million*, WALL ST. J., Apr. 11, 2009, at B2, *available at* http://online.wsj.com/article/SB123940737747310069.html.

90. Antonio Regalado, *Bank to Cover Some Madoff Losses*, WALL ST. J., (Mar. 10, 2009), http://online.wsj.com/article/SB123665403576179839.html (reporting that the investment bank paid $11 million to its clients).

91. *Id.*

92. José de Córdoba & Thomas Catan, *Santander Improves Compensation Offer*, WALL ST. J., Feb. 17, 2009, at C5.

93. Cassell Bryan–Low, *Madoff-Stung Union Bancaire Regroups*, WALL ST. J., Mar. 23, 2009, at C2, *available at* http://online.wsj.com/article/SB123776596117909221.html.

94. *See* Gauthier–Villars, *supra* note 48. For example, Luxalpha reportedly assessed clients a 5% hurdle fee, a 16% performance fee, and a 0.8% annual management fee. *Id.*

vulnerable Merrill Lynch & Co.,[95] access to credit in the commercial paper markets was limited,[96] the government provided insurance to shore up money market funds,[97] the government gave substantial assistance to American International Group,[98] and the Federal Reserve expanded its lending facilities in an effort to stabilize financial markets.[99] So, the revelation that a former chairman of NASDAQ had perpetrated a multibillion-dollar Ponzi scheme over a period of decades undercut any reason for investors to commit capital to markets that seemed fundamentally untrustworthy.[100] A Harrison Group survey showed that 63% of rich Americans had "lost faith in financial institutions."[101] As one observer noted, "If the former chairman of Nasdaq [sic] is a crook, whom do you trust?"[102]

95. *See* Carrick Mollenkamp et al., *Crisis on Wall Street as Lehman Totters, Merrill is Sold, AIG Seeks to Raise Cash*, Wall St. J., Sept. 15, 2008, at A1, *available at* http://online.wsj.com/article/SB122139688846233147.html.

96. *See* Anusha Shrivastava, *Commercial-Paper Market Seizes Up*, Wall St. J., Sept. 19, 2008, at C2, *available at* http://online.wsj.com/article/SB122174858590452493.html.

97. *See* Daisy Maxey, *Money Funds Seek Insurance*, Wall St. J., Oct. 2, 2008, at C7, *available at* http://online.wsj.com/article/SB122291097601796803.html.

98. *See* Matthew Karnitschnig et al., *U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, Wall St. J., Sept. 17, 2008, at A1, *available at* http://online.wsj.com/article/SB122156561931242905.html ("[B]ailout caps a tumultuous 10 days that have remade the American financial system.").

99. *See* Jon Hilsenrath & Sudeep Reddy, *Fed Expands Lending Facilities in Bid for Stability*, Wall St. J., Sept. 15, 2008, at A18 (according to Chairman Benjamin Bernanke's prepared statement, the Fed's actions together "with significant commitments from the private sector, are intended to mitigate the potential risks and disruptions to markets").

100. Nicholas von Hoffman, *Bernard Madoff, Trust-Buster*, Nation Dec. 17, 2008, http://www.thenation.com/article/bernard-madoff-trust-buster.

101. *Show Them the Money: The Rich Have Become Disillusioned with the People Who Look After Their Fortunes*, Economist, Apr. 4, 2009, at 5, *available at* http://www.economist.com/specialreports/PrinterFriendly.cfm?story_id=13356628.

102. von Hoffman, *supra* note 100.

D. Impairment of Investor Confidence in Regulators

> Can you imagine just waking up one day and finding out someone had stolen all of your life's work and savings . . . . I felt violated, and I had relied on the SEC to protect me, not ever thinking that they would end up acting like co-conspirators or keystone cops.[103]
>
> †Madoff Customer

A number of Madoff investors criticized the Commission and other regulatory authorities, in one case describing regulators as "Madoff's tools."[104] These investors were "devastated by the SEC's failure to uncover Madoff's fraud"[105] and generally were disappointed with "those agencies that were set up to protect [them]."[106] One elderly woman described the Madoff investors as "the remnants of stunning indifference."[107]

1. Systemic Failures by the Commission's Staff

Indeed, Madoff had come to the Commission's staff's attention when the Commission brought an enforcement action against two Florida accountants, whom the Commission charged had engaged in unregistered distributions of securities, and promised investors "hard-to-believe annual returns of 13.5% [to] 20%—to be obtained by turning the money over to be managed by an unnamed broker."[108]

---

103. Transmittal Letter and Exhibits, *supra* note 10, at 41 (quoting a former real estate developer and investor who had two accounts with Madoff).
104. Transcript of Sentencing, *supra* note 37, at 10–11, 16, 23, 30.
105. *Id.* at 16.
106. *Id.* at 30.
107. *Id.* at 23.
108. Randall Smith, *Wall Street Mystery Features a Big Board Rival*, WALL ST. J., Dec. 16, 1992, at C1, *available at* http://online.wsj.com/article/SB122909929808301893.html ("Madoff says he didn't know the money he was managing had been raised illegally . . . . 'I would be surprised if anybody thought that matching the S&P over 10 years was anything outstanding,' he says."); *see also Follow the Feeders*, *supra* note 89, at 55 ("The [Commission] gave short shrift to those who suspected him of wrongdoing—including Harry Markopolos, an erstwhile rival who in 2005 sent the commission a 19-page analysis entitled 'The world's largest hedge fund is a fraud.' The report listed 29 'red flags' that, taken together, strongly suggested the Madoff operation's returns were either fictitious or due to front-running (trading one's own account ahead of filling client orders).").

In May 1999, Harry Markopolos, a self-described "derivatives expert," initially presented "observations" (enumerating *twenty-nine red flags*) to the Commission's Boston Regional Office in support of his view that Madoff's hedge fund was a fraud.[109] Markopolos continued to press the matter with the Commission staff for almost a decade.[110] In each instance, the Boston Regional Office referred the matter to the Commission's New York Regional Office; however, Markopolos was not convinced that the staff of the New York Regional Office "had the derivatives or mathematical background to understand the violations."[111] Although Markopolos was not aware of efforts by the staff to investigate Madoff, Massachusetts regulators alleged that Madoff had "coached" officials of a hedge fund to prepare them for their interview with the Commission's staff.[112]

After acknowledging "multiple failures over at least a decade to thoroughly investigate [credible and specific] allegations or at any point to seek formal authority to pursue them," then-Chairman Christopher Cox directed the Commission's Office of Inspector General to conduct a "full and immediate review of the past allegations regarding Mr. Madoff and his firm and the reasons they were not found credible."[113]

109. THE WORLD'S LARGEST HEDGE FUND IS A FRAUD, Submission to the SEC 1 (2005), *available at* http://www.sec.gov/news/studies/2009/oig-509/exhibit-0293.pdf (anonymously submitted by Markopolos, citing concerns for his "personal safety" and that of his family).

110. Michael R. Crittenden, *Markopolos Blasts SEC for 'Financial Illiteracy*,' WALL ST. J., Feb. 4, 2009, at C4 (reporting that Markopolos did not bring his insights to the attention of the Federal Bureau of Investigation because he did not believe he would be taken seriously given "the SEC's decision not to pursue the case" or to FINRA "because of the Madoff family's connections to FINRA.").

111. Email from Harry Markopolos to Jonathan Sokobin, SEC, (Apr. 2, 2008, 11:13 AM), *available at* http://sec.gov/news/studies/2009/oig-509/exhibit-0398.pdf. Markopolos also mentioned a second-hand report of a hedge fund manager who withdrew "significant assets" out of Madoff's fund after that manager "discovered that none of the Madoff trade tickets [for his fund] matched any time & sales reports on [Options Price Reporting Authority]." *Id.*

112. Robert Frank & Tom Lauricella, *Madoff Feeder Is Charged in Fraud*, WALL ST. J., Apr. 2, 2009, at C1, *available at* http://online.wsj.com/article/SB12385930 7450378115.html ("The complaint [filed by Massachusetts regulators] . . . says Mr. Madoff coached officials at Fairfield Greenwich Group on how to deflect questions from Securities and Exchange Commission investigators.").

113. Press Release, Christopher Cox, Chairman, SEC, Statement Regarding Madoff Investigation, (Dec. 16, 2008), *available at* http://sec.gov/news/press/2008/2008-297.htm. H. David Kotz, Inspector General of the Commission, testified that his office's investigation will examine (1) how the Commission's staff handled the Madoff complaints, including whether the staff complied with the Commission's

The Office of Inspector General (OIG) concluded that the Commission had received "numerous substantive complaints since 1992" about Madoff's activities, which should have led the staff to question "whether Madoff was actually engaged in trading" and to initiate a "thorough examination and/or investigation of the possibility that Madoff was operating a Ponzi scheme."[114] According to the OIG, the Commission could have "uncovered" Madoff's fraudulent scheme well in advance of his confession in December 2008 had the staff engaged in "appropriate follow-up" of the five examinations of Madoff's operations.[115] These failures, however, were not found to have been the result of staff "misconduct" or "inappropriate influence" exerted by senior staff but rather reflected "systematic breakdowns" in the conduct of the Commission's examination and investigation program.[116]

policies and procedures; (2) alleged conflicts of interest involving Commission officials or staff and Madoff family members, and the impact those relationships may have had on the Commission's regulatory examinations and oversight of Madoff and related entities; (3) the efficacy of the Commission's examination program for Madoff and related entities, and whether failures to conduct "timely reviews or examinations of Bernard Madoff's activities and filings" violated the Commission's policies and procedures; and (4) whether "decisions regarding investigations, examinations and inspections" of Madoff entities may have been affected by Madoff's prominence in the securities industry, participation on Commission-sponsored advisory committees, and "social and professional relationships with SEC officials." *Testimony Before H. Comm. on Financial Services*, 111th Cong. (2009), *available at* http://www.sec.gov/news/testimony/2009/ts010509hdk.htm (statement of H. David Kotz, Inspector Gen., SEC); *see also* Patrick Jenkins, *SEC Blamed for Failing to Spot Madoff Fraud* (July 3, 2009), http://www.ft.com/cms/s/0/ee1591a2-6726-11de-925f-00144feabdc0 ("[The Commission's staff] had always 'lacked the sophistication and skillset' necessary to do their jobs effectively. The SEC was staffed with too many lawyers and not enough economists and market practioners [sic]."); Frank & Efrati, *supra* note 38, at A1 ("The case has also highlighted shortcomings of financial watchdogs, particularly the Securities and Exchange Commission, which failed to catch the crime despite repeated warnings."); Ianthe Jeanne Dugan & David Crawford, *Accounting Firms that Missed Fraud at Madoff May Be Liable*, WALL ST. J., Feb. 18, 2009, at C1 ("Some critics also blame the SEC . . . [which] suspended the rule [that required auditors of] private financial partnerships, such as hedge funds" to be registered with the Public Company Accounting Oversight Board, which was established "to help detect fraud."); von Hoffman, *supra* note 100, at 2 ("Fear, confusion and mistrust have been amplified by the absence of government supervision, regulation or policing. The Securities and Exchange Commission admits it did not do its job.").

114. SEC, OFFICE OF INVESTIGATION, REPORT NO. OIG-509, INVESTIGATION OF FAILURE OF SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME: PUBLIC VERSION 456 (2009), *available at* http://www.sec.gov/news/studies/2009/oig-509.pdf.
115. *Id.*
116. *Id.* at 457.

III. INVESTOR SOPHISTICATION: A PROXY FOR FEDERAL OVERSIGHT

The private-offering exemption is practically sacrosanct in federal securities law. This exemption allows issuers to raise capital from purchasers who are sophisticated investors without complying with the public-disclosure-oriented registration régime of the Securities Act of 1933.[117]

As interpreted by the Supreme Court of the United States, the legislative policy underlying this statutory exemption is premised on the view that the disclosure régime would offer little benefit for sophisticated investors because this class of investors has access to information that these investors deem important for their respective investment decisions.[118] Thus, sophisticated investors are considered to have the wherewithal to "fend for themselves"[119] in the capital markets.

The federal regulatory approach requires registration for nonexempt securities and transactions.[120] In lieu of registration, the statute substitutes "private" monitoring of disclosures in private placements.[121] Through their role in the private placement, sophisticated investors can attain similar ends as would occur under the registration régime.[122] Consequently, their status as sophisticated investors effectively functions as a proxy for direct oversight by federal authorities of material disclosures that issuers would be required to provide to their investors.[123]

In this section, I summarize the legislative history of the disclosure-oriented régime of the Securities Act and the private-offering exemption afforded by Section 4(2). Next, I discuss the Supreme Court's interpretation of *Ralston Purina*, which defined the scope of the private-offering exemption. However, the application of *Ralston Purina*'s principles required difficult, largely subjective judgments

117. Securities Act of 1933 Section 4(2), 15 U.S.C. § 77d (2006).

118. *See* SEC v. Ralston Purina Co., 346 U.S. 119, 125–27 (1953) (interpreting the scope of the private offering exemption afforded by Section 4(2) of the Securities Act, the Court stated the "focus of inquiry should be on the need of the offerees for the protections afforded by registration. The employees here were not shown to have access to the kind of information which registration would disclose.").

119. *Id.* at 125 ("An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'").

120. *See* 15 U.S.C. § 77c–d.

121. *See Ralston Purina Co.*, 346 U.S. at 124–25.

122. *See infra* Part II.B.

123. *See infra* Part II.D.

concerning the sophistication of investors.[124] Therefore, Congress and the Commission responded by adopting the accredited investor definition to provide an objective standard for assessing investor sophistication within the meaning of the private-offering exemption.[125] I conclude this section with the policy considerations that underlie the treatment of sophisticated investors who participate in transactions pursuant to the private-offering exemption.

A. Legislative History—An Overview

The period leading up to the 1929 Stock Market Crash was characterized by confidence that the newly established Federal Reserve, "with its ability to control interest rates and conduct open market operations . . . [, was] . . . 'the remedy to the whole problem of booms, slumps, and panics.'"[126] The prices of securities traded on securities markets often were "susceptible to manipulation and control."[127] Speculators—including celebrities—borrowed money to invest in the stock market, "[using] debt to pyramid investments and enhance gains."[128] "Excessive speculation"[129] coupled with buying securities with borrowed funds drained credit that could have been made available for "trade, industry, and transportation in interstate commerce."[130] The two-year period leading up to the 1929 Crash was described as an "abandonment of the analytical approach" in favor of a "pseudo-analysis [of facts and figures] to support the delusions of the period."[131]

In the aftermath of the crash as the nation endured the Great Depression, President Franklin D. Roosevelt urged support for "[f]ederal supervision of traffic in investment securities in interstate

124. *See infra* Part II.B.
125. *See infra* Part II.C.
126. EDWARD CHANCELLOR, DEVIL TAKE THE HINDMOST: A HISTORY OF FINANCIAL SPECULATION 192 (2000).
127. Securities Exchange Act of 1934, 15 U.S.C. § 78b (2006).
128. *See* CHANCELLOR, *supra* note 126, at 207.
129. BENJAMIN GRAHAM & DAVID DODD, SECURITY ANALYSIS: THE CLASSIC 1940 SECOND EDITION 66 (2d ed. 1962) (stating that in contrast to investment, "[s]peculation . . . may always properly—and often soundly—derive its basis and its justification from prospective developments that differ from past performance."); THOMAS SOWELL, BASIC ECONOMICS: A COMMON SENSE GUIDE TO THE ECONOMY 262 (3d ed. 2007) (stating that unlike gambling where one seeks "to profit or exhibit one's skill or lack of fear" by "[creating a risk that would otherwise not exist], . . . economic speculation involves . . . coping with an *inherent* risk in such a way as to minimize it and to leave it to be borne by whoever is best equipped to bear it.").
130. 15 U.S.C. § 78b.
131. GRAHAM & DODD, *supra* note 129, at 17.

commerce,"[132] given "severe losses [sustained by the public] through practices neither ethical nor honest on the part of many persons and corporations selling securities."[133] For example, of the estimated "[fifty] billions of new securities offered in the post-war decade, 'half . . . have been proved to be worthless.'"[134] The House Report observed that

> [t]hese cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities. The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise. Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security. High-pressure salesmanship rather than careful counsel was the rule in this most dangerous of enterprises.[135]

As a response to these abuses and the harm to domestic industry and capital markets, Congress enacted the Securities Act, the first of the New Deal securities statutes.[136] The purpose of the Securities Act is to "provide full and fair disclosure of the character of securities sold in interstate and foreign commerce . . . and to prevent frauds in the sale" of securities.[137] This is accomplished principally by requiring registration of public offerings with the Commission and generally imposing civil liability and criminal sanctions on issuers, directors and officers of issuers, underwriters, and accountants for prospectuses or oral communications that include omissions or misstatements of material information.[138]

Consistent with President Roosevelt's letter to Congress,[139] the Securities Act did not provide a federal guarantee or approval for

132. H.R. DOC. NO. 73-12, at 1 (1933).
133. *Id.*
134. H.R. REP. NO. 73-85, at 2 (1933) (Conf. Rep.).
135. *Id.*
136. Securities Act of 1933, 15 U.S.C. § 77a (2006).
137. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a-aa (2006)).
138. 48 Stat. 74 §§ 11, 12(a)(2), 17, 20(d), 24 (2010).
139. H.R. DOC. NO. 73-12, at 1 (1933).

securities issued in registered public offerings.[140] Rather than regulate the "merit" of particular offerings (as was common under some state blue-sky laws),[141] the disclosure régime applied "sunshine [as] the best of disinfectants; electric light the most efficient policeman."[142] Therefore, the Commission's role is to determine whether the information filed in the registration statement is complete and accurate on its face.[143] The Commission may exercise its authority to prevent a public distribution of securities before or after effectiveness of the registration statement.[144] Prior to the effective date of the registration statement, the Commission may prevent effectiveness if the registration statement appears to be "incomplete or inaccurate in any material respect."[145] After the registration statement becomes effective, the Commission may suspend effectiveness if the registration statement appears to contain any material misstatement or omission.[146] Any refusal order issued under Section 8(b) or stop order issued under Section 8(d) would continue in effect until the registration statement was amended to comply with the order.[147] Although the Commission does not have statutory authority to regulate the merits of a public offering, it has considerable power to protect investors when evidence shows that material information concerning the securities is false or misleading.[148]

Congress provided an exemption from the registration requirement for "certain types of securities and securities transactions where there

---

140. *Id.*

141. These state securities statutes were so-named because they were intended to protect the public from "speculative schemes which have no more basis than so many feet of 'blue sky.'" Hall v. Geiger–Jones Co., 242 U.S. 539, 551 (1917). By the time of the 1929 Stock Market Crash, forty-seven states had enacted blue-sky laws. S. Rep. No. 73-47, at 2 (1933).

142. Louis D. Brandeis, Other People's Money and How the Bankers Use It 92 (2nd prtg. 1914) (commending the salutary effect of "[p]ublicity . . . as a remedy for social and industrial diseases"); H.R. Rep. No. 73-12, at 1 ("There is . . . an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.").

143. H.R. Rep. No. 73-85, at 4 (1933) (Conf. Rep.).

144. Securities Act of 1933, 15 U.S.C. § 77h(b), (d). In both instances, the Commission must give notice and afford the registrant an opportunity for a hearing before issuing any order of § 8(b) or (d) of the Securities Act. *Id.*

145. § 77h(b).

146. § 77h(d).

147. § 77h(b), (d).

148. Securities Act of 1933, ch. 38, 48 Stat. 74 §§ 11, 12(a)(2), 17, 20(d), 24 (2010); 48 Stat. 881 §§ 10(b), 21(d)(3)(B) (2010); 17 C.F.R. § 240.10b-5 (2010).

is no practical need for its application or where the public benefits are too remote."[149] These transactions are not exempt from the anti-fraud provisions of federal securities law.[150]

One of the exemptions from the registration régime is the private-offering exemption in Section 4(2) of the Securities Act, which provides an exemption for "transactions by an issuer not involving any public offering."[151] The purpose of this exemption is to "permit an issuer to make a specific or isolated sale of its securities to a particular person" so long as the transaction does not involve a distribution of securities to the public.[152]

B. Scope of the Private-Offering Exemption

One of the early issues raised by the private-offering exemption concerned the nature of the offerees to whom issuers may privately offer securities.[153] In his interpretative letter, the Commission's general counsel discussed the importance of the offerees' relationship with each other and to the issuer.[154] He construed the exemption for the private offering as one made to "members of the class who should have special knowledge of the issuer."[155] As an example, he observed the "special relationship" enjoyed by an issuer's high executive officers, a relationship not available to subordinate employees.[156]

149. H.R. REP. NO. 73-85, at 5.
150. 15 U.S.C. §§ 77l, 77q, 78j; 17 C.F.R. § 240.10b-5 (2010).
151. 15 U.S.C. § 77d(2). The issuer, however, bears the burden of establishing that the exemption is available for its private offering transaction, given the "broadly remedial purposes" of the statute. SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953).
152. *See* H.R. REP. NO. 73-85, at 15–16 (exempting issuer transactions where the services of an underwriter are not used). A subsequent amendment excised the phrase "not with or through an underwriter" as superfluous language because the presence of an underwriter is the essence of a public offering. *See* Securities Exchange Act of 1934, ch. 404, 48 Stat. 906; H.R. REP. NO. 73-1838, at 41 (1934); *see also* Allen E. Throop & Chester T. Lane, *Some Problems of Exemption Under the Securities Act of 1933*, 4 LAW & CONTEMP. PROBS. 89, 114 (1937) ("The registration and prospectus requirements relate only to distributions which are public in character.").
153. Letter of General Counsel Discussing the Factors to Be Considered in Determining the Availability of the Exemption from Registration Provided by the Second Clause of Section 4(1), Securities Act Release No. 285, 11 Fed. Reg. 10,952 (Jan. 24, 1935).
154. *Id.* (showing that other relevant factors were the number of offerees, number of units offered, and the size and manner of the offering).
155. *Id.* at 2.
156. *Id.*

SEC v. Ralston Purina[157] is the seminal case to interpret the scope of the private-offering exemption. Pursuant to its policy of encouraging employee ownership of its common stock, Ralston Purina sold common stock to employees who had expressed an interest in acquiring the stock.[158] During a four-year period, the company sold shares to 1088 employees in over fifty widely dispersed communities.[159] The Commission sought to enjoin the company from offering its common stock without complying with the registration requirements of Section 5 of the Securities Act.[160]

Ralston Purina claimed that its transactions were exempt from registration in reliance on the private-offering exemption of Section 4(2) because all offerees were "key employees."[161] The company asserted that its designation of key employees was not based solely upon an employee's status within the organizational chart, but also included other salient factors such as eligibility for promotion, ability to influence others, bearing a "special responsibility," or being "sympathetic to management, . . . ambitious, . . . and likely to be promoted to greater responsibility" by management.[162] In any event, the company's offerees included an artist, a chow-loading foreman, a copywriter, an electrician, a mill office clerk, a production trainee, a stenographer, and a veterinarian.[163]

The Supreme Court of the United States considered the legislative history in its interpretation of the private-offering exemption and noted that the exemption was intended for those transactions for which "there is no practical need . . . for (the bill's) application."[164] Since the Securities Act established a disclosure-oriented registration régime for public offerings, the Court determined that the availability of the private-offering exemption should be based on "whether the particular class of persons affected need[s] the protections of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'"[165] Finally,

157. 346 U.S. 119 (1953).
158. *Id.* at 121. Pursuant to the board resolution, the program was to be made available to those employees who exercised the initiative to inquire about purchasing the company's common stock, without solicitation by the company, its officers, or employees. *Id.*
159. *Id.* Of an estimated 500 offers, 165 purchase applications were pending in 1951, when the Commission instituted litigation. *Id.*
160. *Id.* at 119.
161. *Id.* at 121.
162. *Id.* at 121–22.
163. *Id.* at 121.
164. *Id.* at 124–25.
165. *Id.* at 125.

although the Commission had "consistently interpreted" the private-offering exemption as being unavailable for transactions involving "a large number of offerees," the Court declined to read into the statute any quantitative limitation.[166]

Based on this statutory interpretation, the Court considered the company's employees to be no less members of the public than their neighbors.[167] The Court ultimately determined that the company's offering must comply with the registration provisions of Section 5 because there was no showing that these employees had "access" to the type of information that would have been provided in a Securities Act registration statement.[168]

However, the Court noted that special circumstances may warrant treating an offering to a particular class of employees as a private offering.[169] For example, an offering to a company's executives "who because of their position have access to the same kind of information that the act would make available in the form of a registration statement" would be one such special circumstance.[170] In its focus on the relationship between the company and the offerees, the Court adopted the "special relationship" factor of the Commission's general counsel.[171] Thus, as interpreted by the Court, Section 4(2) would provide an exemption for private offerings made by issuers to a particular class of persons (i.e., sophisticated investors) who have access to similar information as would be made available in a registered offering.[172]

Following adoption of the Securities Act, institutional investors (particularly insurance companies) and "a few closely related persons" providing capital to business ventures were among the types of sophisticated investors who traditionally participated in private

166. *Id.* ("[N]othing prevents the commission, in enforcing the statute, from using some kind of numerical test in deciding when to investigate particular exemption claims.").
167. *Id.* at 126.
168. *Id.* at 127; *see also* Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 903 (5th Cir. 1977) ("[A]ccess [to information means] a relationship based on factors such as employment, family, or economic bargaining power that enables the offeree effectively to obtain such information.").
169. *Ralston Purina Co.*, 346 U.S. at 126.
170. *Id.* at 125–26.
171. *Id.* at 126 n.12 (quoting Letter of General Counsel Discussing the Factors to Be Considered in Determining the Availability of the Exemption from Registration Provided by the Second Clause of Section 4(1), Securities Act Release No. 285, 11 Fed. Reg. 10,952 (Jan. 24, 1935).
172. *Id.* at 127.

offerings.[173] The Commission created the concept of "accredited person" to provide issuers with an objective means to gauge the sophistication of an offeree or purchaser for purposes of the limited-offering exemption of Section 3(b) of the Securities Act.[174] The issuer's ability to rely on the new rule was predicated on the issuer (or its agent) having a reasonable belief, after due inquiry, that the purchaser was an accredited person at the time of sale.[175] Accredited persons comprised three categories of investors: certain banks, insurance companies, investment companies, small business investment companies, and employee-benefit plans; any purchaser of at least $100,000 of securities sold by the issuer in reliance on Rule 242; and an issuer's directors and executive officers.[176]

C. Accredited Investors

In 1980, Congress amended the Securities Act, in part, to provide incentives for small business investment.[177] The amendments included a definition of "accredited investor" and enumerated certain institutions that would qualify as accredited investors[178] (these institutional investors were identical to those entities that were included in the accredited person definition of Rule 242).[179] The statute also authorized the Commission to define accredited investors based on considerations such as a person's "financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management."[180]

The Commission used this rulemaking authority to promulgate Rule 501(a)[181] of Regulation D,[182] which set forth particular criteria

173. Non-Public Offering Exemption, Securities Act Release No. 33-4552, 27 Fed. Reg. 11,316 (Nov. 6, 1962); Letter of General Counsel, *supra* note 153.

174. Exemption of Limited Offers and Sales by Qualified Issuers, Securities Act Release No. 33-6180, 45 Fed. Reg. 6362, 6363 (Jan. 28, 1980). Rule 242, which was intended to facilitate small business capital formation, was adopted as an experiment by the Commission. *Id.* The Commission announced its intention to evaluate Rule 242 during the monitoring period, and determine whether to retain the Rule or revise the conditions for its use. *Id.* at 6362.

175. 17 C.F.R. § 230.242(a)(1) (1981). The issuer (or its agent) was required at the time of sale not only to believe that the purchaser was an accredited person, but to have reasonable grounds for its belief. *Id.*

176. *Id.* § 230.242(a)(1)(i)–(iii).

177. Small Business Investment Incentive Act of 1980, Pub. L. 96-477, 94 Stat. 2275.

178. Securities Act of 1933, 15 U.S.C. § 77b(a)(15)(i) (2006).

179. 17 C.F.R. § 230.242(a)(1).

180. 15 U.S.C. § 77b(a)(15)(ii).

181. 17 C.F.R. § 230.501(a) (2009).

for determining whether specific categories of institutions or individuals would qualify as accredited investors. The Rule added the following entities to the statutory definition of accredited investor: private business development companies, tax-exempt entities with assets in excess of $5 million, and entities owned solely by accredited investors.[183] Categories of natural persons who likewise would qualify as accredited investors were based on either a special relationship with the issuer,[184] net worth,[185] or annual income.[186]

Consistent with the non-public nature of Section 4(2) offerings, general solicitation or general advertising is proscribed by Regulation D.[187] Additionally, Rule 506 permits offerings to an unlimited number of accredited investors and up to thirty-five purchasers who have (or the issuer reasonably believes they have) the requisite expertise to evaluate the risks and merits of the proposed investment.[188]

182. *See* Revisions of Certain Exemptions from Registration for Transactions Involving Limited Offerings and Sales, Securities Act Release No. 33-6389, 47 Fed. Reg. 11251, 11258 (Mar. 16, 1982) (Rule 506 of Regulation D provides a non-exclusive "safe harbor" that issuers may use to effect a private offering under Section 4(2)).

183. *Id.* at 11253. In 1983, the entities that qualified as accredited investors were expanded to include certain savings and loan associations, insured credit unions, registered broker-dealers, and trusts, partnerships and corporations whose assets exceed $5 million. Regulation D Revisions, Securities Act Release No. 33-6758, 53 Fed. Reg. 7866, 7866–67 (Mar. 10, 1988).

184. This category would encompass the issuer's directors, executive officers, and general partners. Revisions from Certain Exemptions from Registration for Transactions Involving Limited Offerings and Sales, Securities Act Release No. 33-6389, 47 Fed. Reg. 11251, 11254 (Mar. 16, 1982).

185. This test established a minimum net worth of $1 million for a natural person (individually, or jointly with the person's spouse). *Id.* at 11255.

186. Initially, the income test required an individual to have a minimum annual income of $200,000 for each of the prior two years, and a reasonable expectation of at least $200,000 for the current year. *Id.* at 11255. The income test subsequently was revised to incorporate income of one's spouse, thereby expanding the income threshold to $300,000. Regulation D Revisions, Securities Act Release No. 33-6758, 53 Fed. Reg. 7866, 7867 (Mar. 10, 1988). The Commission also rescinded the accredited investor standard available for a purchaser of a significant dollar amount of securities. *Id.* Under the "purchaser test," one would be required to purchase a minimum of $150,000 of securities where the total purchase price would not exceed 20% of the purchaser's net worth (individually, or jointly with the purchaser's spouse) at the time of purchase. Revision of Certain Exemptions from Registration for Transactions Involving Limited Offerings and Sales, Securities Act Release No. 33-6389, 47 Fed. Reg. 11251, 11254 (Mar. 16, 1982).

187. 17 C.F.R. § 230.502(c) (2010).

188. 17 C.F.R. §§ 230.501(e), 230.506(b)(2) (2010).

Indicia of investor sophistication include wealth, business experience, and financial acumen.[189] Given their wealth and their knowledge of business and financial matters, sophisticated investors are considered to have the ability to "fend for themselves,"[190] and thus have "no practical need" for the protection that a registered offering would provide.[191]

D. Policy Considerations

Certainly, the magnitude of losses to public investors and the collapse of confidence in U.S. capital markets following the 1929 Stock Market Crash justified a reliance on disclosure to cure the deficiencies in the new issues market.[192] To the extent that sophisticated investors were thought to have a special relationship with issuers, or to have sufficient skills, resources, or bargaining strength *vis-à-vis* issuers to see after their own interests, there was no practical need for a federal statute to give these investors essentially similar information about the securities that they could readily procure for themselves.[193] The net result was that government oversight focused on disclosures made in public distributions of securities rather than transactions[194] with those who have the ability to fend for themselves.[195] As a consequence, rather than rely on government oversight of disclosure in private offerings,[196]

189. 15 U.S.C. § 77b(a)(15)(ii) (2006); *see also* Doran v. Petroleum Mgt. Corp., 545 F.2d 893, 902 (5th Cir. 1977) (noting that Doran's specialized education as a petroleum engineer, estimated net worth of $1 million, and oil and gas investment portfolio valued at $850,000 evidenced his investment sophistication).

190. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

191. *Id.* at 124–25.

192. *See supra* Part II.A and accompanying notes.

193. *See supra* Part II.B (discussing The Securities Act of 1933 as interpreted by the Supreme Court in *Ralston Purina Co.*, 346 U.S. 119).

194. *See supra* note 150 and accompanying text.

195. *See Ralston Purina Co.*, 346 U.S. at 125; Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1064 (2009). From one perspective, the ability to bear "losses" identifies that class of investors for whom the protections of the securities laws are not needed. *See, e.g.*, *id.* at 1064 ("[Wealthy and diversified institutional investors] can and do suffer from issuer concealment, but rarely drastically. As such, they can more easily be told simply to learn from the experience, not repeat the mistake, and seek damages if fraud can be proven.").

196. *See* Doran v. Petroleum Mgmt. Corp., 545 F.2d 893, 904 (5th Cir. 1977) ("The Act is practical and pragmatic, not dogmatic and doctrinaire. It is designed to give a panoply of protection to the investor, but also to allow play in the marts of trade for offers of securities that do not require the oversight of the Securities and Exchange Commission.").

sophisticated investors became, in effect, a proxy for direct government regulation.[197] For those investors who participate in private offerings of securities by issuers who are not subject to the annual and periodic reporting requirements of the Securities Act,[198] they implicitly accept the risk of a lack of prescribed disclosures and lack of transparency[199] that is characteristic of publicly held issuers. Again, given the sophistication of these investors, they are left to their own devices to bargain for the type of information about their investment and timing of that disclosure that would be acceptable to them.

IV. THE LIMITS OF THE SOPHISTICATED INVESTOR OVERSIGHT MODEL

What the Madoff fraud seemingly exposed was an astonishing lack of critical diligence by numerous sophisticated investors.[200] Given the vast sums invested with Madoff, these investors had every incentive—and the means—to look after their own interests, whether they were acting in a fiduciary capacity or on their own behalves.[201] Nonetheless, a number of them seemed unable or unwilling to fend for themselves.

Although the Commission has taken a number of steps to rectify weaknesses in its enforcement and inspection programs[202] and instituted reforms that address, *inter alia*, a lack of structural controls that Madoff exploited to the detriment of his investors,[203] the question

197. *See Ralston Purina Co.*, 346 U.S. at 125, 127.

198. 15 U.S.C. §§ 78m, 78o(d) (2006).

199. For example, the MD&A requirements of Regulation S-K, Item 303, 17 C.F.R. § 229.303 (2009), are "intended to give the investor an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the [company's business]." Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Securities Act Release No. 6,711, 52 Fed. Reg. 13717 (Apr. 24, 1987).

200. *See infra* notes 205–07 and accompanying text.

201. *See supra* notes 11, 59–60 and accompanying text.

202. *The Securities and Exchange Commission Post-Madoff Reforms*, SEC. & EXCH. COMM'N, http://sec.gov/spotlight/secpostmadoffreforms.htm (last modified Dec. 7, 2009).

203. An example of a structural reform was the "expan[sion of] protections" for clients when the Commission "eliminate[d] certain exemptions" in Rule 206(4)-2 under the Investment Advisers Act of 1940. Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2968, 75 Fed. Reg. 1456, 1456 (Jan. 11, 2010). As part of its regulatory response to Madoff's Ponzi scheme, the Commission amended rule 206(4)-2, which became effective on March 12, 2010, that subjects any registered investment adviser who, in its capacity as a qualified custodian, maintains

still remains: *Why was there an apparent failure to perform the diligence that first and foremost was in investors' economic interests?*

A. *Diligence by Madoff Investors*

> "Remember, O Stranger, Arithmetic is the first of the sciences and the mother of safety."[204]
> †Louis D. Brandeis

> "'It's very easy if you want [to discover a Ponzi scheme]. You must do a third party [sic] check. It's absolutely a must. . . . It's Accounting 101 to look at [Depository Trust Company], do a box count' if you are looking for a Ponzi scheme."[205]
> †Bernard L. Madoff

---

custody of client assets to an annual surprise examination (or audit) of client assets (the "Madoff Rule"). The surprise examination must be conducted by an independent public accounting that is subject to regulation by the Public Company Accounting Oversight Board ("PCAOB"). *Id.* at 1457. The adviser also would be subject to a surprise examination if its client's assets were held by any of the adviser's related persons, and the related person must furnish to the adviser a report on its internal controls for its custodial operations that was prepared by an accounting firm regulated by PCAOB. *Id.* An adviser that is subject to surprise examination may furnish account statements to its clients. *Id.* Where client assets are held by a qualified custodian (*i.e.*, a bank, registered broker-dealer, or registered futures commission merchant), the adviser is required to have a "reasonable belief that the qualified custodian sends account statements directly to advisory clients." *Id.* at 1456; *see also Staff Responses to Questions About the Custody Rule*, SEC. & EXCH. COMM'N, http://www.sec.gov/divisions/investment/custody_faq_030510.htm (last modified Sept. 9, 2010). Notwithstanding the Commission's rulemaking, Congress also amended the Advisers Act to mandate that registered investment advisers "safeguard client assets" pursuant to rules adopted by the Commission. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 411, 124 Stat. 1376, 1577 (2010) [hereinafter Dodd–Frank Act] (to be codified at 15 U.S.C. § 80b-18b). Section 412 of the Dodd–Frank Act also requires the Comptroller General of the United States to assess compliance costs of the Commission's custody rule and costs associated with the elimination of the Commission's "operational independence" provision. *Id.* In written testimony to the Senate Committee on Banking, Housing, and Urban Affairs, Professor John Coffee stated that Section 411 would "eliminate[ ] the ability of the manager to recycle' [sic] funds from new to old investors." S. REP. NO. 111-176, at 77 (2010) (citations omitted).

204. Norman Hapgood, *Preface* to LOUIS D. BRANDEIS, *supra* note 142, at xli (citing a private letter Mr. Brandeis sent to him with a suggested "epitaph or obituary notice" for Mr. Mellen of the New Haven Railroad).

205. *Interview of Bernard L. Madoff*, SEC. & EXCH. COMM'N, 7, http://www.sec.gov/news/studies/2009/oig-509/exhibit-0104.pdf (last visited January 6, 2011).

> "All it took was simple math—'What's the open interest of the S&P 100 option, and how many trades does he say he's making?'"[206]
> †Joe Kinahan

Apparently, a number of sophisticated individual or institutional investors—or professional money managers acting on their behalves—may have conducted, at most, pro forma diligence on Madoff's investment program before tendering millions—and sometimes billions—of dollars to him to invest for them or their clients.[207] Investors or their professional money managers may not have adequately scrutinized Madoff's investment program for any number of reasons. Madoff's prominence on Wall Street may have obviated the need to conduct customary diligence.[208] Years of steady "investment returns" may have lulled investors into disregarding potentially troubling signs.[209] The aura of exclusivity that Madoff cultivated among his investors, together with his social prominence

206. Rob Curran, *Traders Say Madoff's Strategy Was Unworkable*, WALL ST. J., Dec. 24, 2008, at C5 (quoting the chief derivatives strategist as think-or-swim).

207. *See Madoff's Victims*, *supra* note 11. Of course, fund managers profited handsomely from management fees paid by fund investors. *See* Gauthier–Villars, *supra* note 48, at C1 (stating that the Luxalpha Sicav fund assessed a "'hurdle' fee of 5%, a performance fee of 16%, and an annual management fee of 0.8%"); Lauricella, *supra* note 89, at B2 (stating that investors reportedly paid in the aggregate about $790 million in management fees.); *see also Show Them the Money*, *supra* note 101, at 5 ("Bernard Madoff pleaded guilty to running a Ponzi scheme in which he was paying early investors consistent returns by taking the money from later ones, with potential losses in the tens of billions of dollars. Just what were wealth managers doing to earn their fees if they could not spot the scam?").

208. *See* Gregory Zuckerman & David Gauthier–Villars, *A Lonely Lament From a Whistle-Blower: Mr. Markopolos Regrets His Failure to Persuade Investors; Tips for the SEC*, WALL ST. J., Feb. 3, 2009, at C3, *available at* http://online.wsj.com/article/SB123361899636241467.html (stating that Madoff was not subjected to International Advisors LLC's customary due diligence "to the same rigor, in part because of Mr. Madoff's reputation on Wall Street"); Strasburg, *supra* note 59, at C1 ("Mr. Madoff's 'background, his associations' were reasons for comfort, Mr. Kaufman said.").

209. *Con of the Century*, ECONOMIST, Dec. 18, 2008, at 119–20 ("Clients . . . seemed not to mind [being kept in the dark] as long as the returns remained strong, accepting that to ask Bernie to reveal his strategy would be as crass as demanding to see Coca-Cola's magic formula."); Greenspan, *supra* note 16, at W1 ("Highly compensated [fund managers] . . . had too good a thing going to entertain the idea that it might all be about to crumble."); *The Grand Illusion*, ECONOMIST, Mar. 7, 2009, at 79 (stating that Madoff's "smooth returns" should have aroused suspicions).

and recognition as a philanthropist also may have been factors.[210] Other investors took comfort either from "verifying" that the Commission's staff "had no issues or concerns with" Madoff[211] or from reading unspecified "SEC reports" on Madoff.[212]

It appears that Madoff was less than cooperative with investors or potential investors who sought to perform a more searching diligence on the investment.[213] Madoff reportedly rebuffed the efforts of an institutional investor who sought greater insight into the "options-based investment strategy"[214] that was integral to Madoff's system.[215] Madoff reportedly not only maintained a level of secrecy about his investment activities, but also insisted that his investors likewise remain behind a veil of secrecy. According to one investment manager, Madoff said, "If you invest with me, you must never tell anyone that you're invested with me. It's no one's business what

---

210. Greenspan, *supra* note 16, at W2 ("Newspaper reports described how wealthy retirees in Florida joined Mr. Madoff's country club for the sole reason of having an opportunity to meet him socially and be invited to invest directly with him . . . . [T]hat Mr. Madoff was a prominent Jewish philanthropist was undoubtedly another situational contributor.").

211. Transmittal Letter and Exhibits, *supra* note 10, at 56 ("We contacted the SEC on several occasions and they verified there were no issues or concerns with Madoff's firm and everything was above board."); SEC, *supra* note 114 (showing that Madoff ensured that wavering prospects knew that the Commission's staff had examined and investigated him and his affiliates and had not detected any fraud, which allayed concerns that prospective investors raised in their diligence of the investment).

212. Transmittal Letter and Exhibits, *supra* note 10 ("[I] read the [SEC] report on madoff and entrusted him with my [IRA].").

213. *See infra* note 214 and accompanying text.

214. Erin E. Arvelund, *Don't Ask, Don't Tell: Bernie Madoff is So Secretive, He Even Asks Investors To Keep Mum*, BARRON'S, May 7, 2001, at 26, *available at* http://barrons.com/article/SB989019667829349012.html. One hedge fund reportedly described Madoff's "split strike conversion" strategy as follows:

> Typically, a position will consist of the ownership of 30–35 S&P 100 stocks, most correlated to that index, the sale of out-of-the-money calls on the index and the purchase of out-of-the-money puts on the index. The sale of the calls is designed to increase the rate of return, while allowing upward movement of the stock portfolio to the strike price of the calls. The puts, funded in large part by the sale of the calls, limit the portfolio's downside.

Id.

215. Aaron Lucchetti & Jenny Strasburg, *Simon's Notion: All In, Then All Out*, WALL ST. J., Feb. 25, 2009, at C1, *available at* http://online.wsj.com/article/SB123553339326867241.html (reporting that, according to a member of Stony Brook University Foundation's investment committee, during their 1993 visit to Madoff's midtown Manhattan office, "Madoff didn't want to discuss details of his options-based investment strategy, but that didn't raise any immediate alarms" because their confidence was assuaged by "Madoff's electronically savvy trading desk.").

goes on here."[216] In other instances, Madoff reportedly did not permit certain inquisitive investors to participate in his investment program[217] or expelled those investors who asked "awkward questions."[218]

However, an attorney for a prominent money manager alleged that his client's efforts to conduct diligence were "thwarted by the intricate, fraudulent scheme perpetrated by Madoff."[219] According to Fairfield Greenwich, Madoff deceived the fund's management and supplied its representatives with "falsified trading documents."[220]

In some cases, investors may have allowed the perceived exclusivity of being a Madoff investor,[221] seemingly implausible investment returns "with limited risk,"[222] or belief that Madoff had special access or market knowledge from which they could benefit[223] to obscure tripwires about Madoff and his investment program.[224]

---

216. Arvelund, *supra* note 214, at 26 ("When he couldn't explain . . . how they were up or down in a particular month . . . I pulled the money out."); *see also Con of the Century*, *supra* note 209, at 119 ("Turning away some investors and telling those he accepted not to talk to outsiders produced a sense of exclusivity.").

217. Robert Frank & Tom Lauricella, *'Uncle Bernie' and His Angry Clients—Madoff Created Air of Mystery*, WALL ST. J., Dec. 20, 2008, at A1, *available at* http://online.wsj.com/article/SB122973208705022949.html ("[Madoff] could be gruff to the people who gave him money to invest, threatening to expel those who asked too many questions.").

218. *Con of the Century*, *supra* note 209, at 120 ("Madoff reinforced the message by occasionally ejecting a client who asked awkward questions."); *see also Dumb Money and Dull Diligence*, *supra* note 60 ("His clients were fiercely loyal; they had to be or he would cut them out of his hallowed investment circle and month-after-month returns of metronomic regularity. And he thrived in an era of cheap credit, when greed and gullibility became far more powerful than fear and suspicion.").

219. Rappaport, *supra* note 89, at A1.

220. Tom Lauricella, *Fairfield Greenwich Says Madoff Provided Bad Data*, WALL ST. J., Mar. 2, 2009, at C2 (stating that, according to Fairfield Greenwich, some of the phony trading documents included "fake electronic records from Depository Trust & Clearing Corp., an independent firm that inventories much of Wall Street's stock and bond holdings"); *see also* SEC, *supra* note 114, at 22 (showing that OIG confirmed that Madoff "kept two sets of records").

221. *See Excerpts: 'We Have Been Very Affected At A Family Level'—Piedrahita on Piedrahita*, WALL ST. J. (Mar. 31, 2009), http://online.wsj.com/article/SB123844004768970611.html ("Sometimes [Madoff] would take money and sometimes not. He created a line of people who wanted in.").

222. Information, *supra* note 8, ¶¶ 3, 8 (alleging that Madoff promised some investors returns of at least 46%).

223. *See* Masters, *supra* note 49 ("Several investors believed he might be front-running—illegally trading ahead of customers of the market-making division—but many stayed with him anyway. 'He had a clean record from the SEC and it wasn't our job to spot this,' says one."); Gauthier–Villars, *supra* note 48, at C1 (referring to a prospectus by

The enforcement and inspection lapses of the Commission's staff concerning Madoff are well-documented in the OIG's report.[225] However, the Commission staff's mistakes should not inculcate money managers or other sophisticated investors from the products of their diligence on the Madoff investment. After all, the basis on which money managers seek to attract assets under management is the reputed financial and investment expertise of the particular money manager.

Many of the same "red flags" raised with the Commission concerning Madoff were no less present in the case of sophisticated investors,[226] who were investing millions (and in some cases billions) with Madoff.[227] For example, the financial statements were not audited by a firm of nationally recognized auditors, but by an otherwise obscure U.S. accounting firm that provided financial auditing services for Madoff.[228]

Madoff reportedly described his firm's role as one of providing investment ideas and executing trades in its capacity as a securities broker,[229] but Mr. Picard stated Madoff's firm apparently had not "bought any securities for clients in at least [thirteen] years."[230] If Madoff was just a broker, there are risk management controls available to institutional investors. For example, they could arrange to have their securities and cash positions transferred to an independent third-party custodian of their choice rather than keep

---

the Luxalpha fund which described Madoff indirectly as a "prominent New York broker . . . [whose] large volume of trades . . . allowed him to anticipate market movements by one or two hours and bet in the right direction 95% of the time.").

224. *See* Zuckerman & Gauthier–Villars, *supra* note 208, at C3 ("Part of the reason he did not press his warnings: Fear of retribution by Mr. Madoff, says Mr. Markopolos."); *Con of the Century*, *supra* note 209 ("On the face of it, the attractions were clear. Mr[.] Madoff's pedigree was top-notch: a pioneering marketmaker, he had chaired NASDAQ, had advised the government on market issues and was a noted philanthropist.").

225. *See* SEC, *supra* note 114.

226. *See* Dugan & Crawford, *supra* note 113, at C1.

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

228. *See* Dugan & Crawford, *supra* note 113, at C1 (reporting that accountants who inspected the books of Madoff or his feeder funds may be "vulnerable to claims they should have uncovered red flags.").

229. Michael Ocrant, *Madoff Tops Charts; Skeptics Ask How*, MAR/HEDGE (RIP), May 2001, at 1, 2. In this case, the investment strategy was a collar (i.e., put and call options) on multiple portfolios comprised of thirty to thirty-five stocks with a high correlation to the S&P 100 index. *Id.* at 1.

230. Ianthe Jeanne Dugan, *Madoff Didn't Buy Securities for Years*, WALL ST. J., Feb. 21, 2009, at B3.

those positions in brokerage accounts at Madoff's firm.[231] This probably would have exposed "phony trades" in real time—or more likely, would have dissuaded Madoff from attempting a fraudulent scheme that could be so readily detected. They also could arrange to receive confirmations of purchases and sales of common stock made for their account[232] via the DTC Institutional Delivery System, which has been available for institutional accounts for over thirty years[233] rather than solely from a brokerage firm.

Some Wall Street professionals had expressed "astonish[ment]" at Madoff's "ability to time the market and move to cash in the underlying securities before market conditions turn negative . . . [and] buy and sell the underlying stocks without noticeably affecting the market."[234] What efforts were made to understand Madoff's option strategy, or at least question the viability of the strategy if like results could not be replicated by Madoff's investors who had the personnel and other resources to engage in sophisticated investment analysis?[235] The "shallow volume" in S&P 100 options contracts also should have caused investors to question Madoff's strategy.[236] What further diligence or other action did sophisticated investors take when the *MAR/Hedge* report and the *Barron's* article[237] were published in May 2001?

But Madoff was not just a broker—he was an investment advisor for a hedge fund. Diligence becomes more acute in a structure where the investment advisor has custody of the fund's cash, securities, and other assets; directs trades to the advisor's affiliated broker; self-clears trades; and does not use a well-known independent auditor.[238]

---

231. *See* Ocrant, *supra* note 229, at 1–2.
232. 17 CFR § 240.10b-10 (2010).
233. Depositary Trust Co., SEC No-Action Letter, [1974–1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,884 (Nov. 29, 1974).
234. *See* Ocrant, *supra* note 229, at 2–3. Most of these financial professionals were "baffled" by Madoff's "consistent, nonvolatile returns month after month and year after year." *Id.* at 1.
235. *See id.* at 2–3.
236. Curran, *supra* note 206, at C5. While Madoff was believed to manage $50 billion of assets using his proprietary options strategy, the entire S&P 100 options would have protected only $3.25 billion of stock as of the end of November 2008. However, based on FactSet data, the "open interest in S&P 100 contracts showed that nobody owns more than 6,000 contracts at any single strike price." *Id.*
237. *See* Arvelund, *supra* note 214, at 26.
238 *See* Sec. Investor Protection Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Bernard L. Madoff Inv. Sec, LLC), 424 B.R. 122, 126–29 (Bankr. S.D.N.Y. 2010) (describing the BLMIS structure and customer agreement); *Dumb Money and Dull Diligence*, *supra* note 60 ("Yet for all [hedge fund managers'] insights and access, some of them

Ultimately, why did they invest with Madoff even in the absence of reasonable transparency by Madoff in his activities *with their money or their clients' money*?[239] Conversely, how many smaller, albeit accredited, investors who reportedly invested their life savings with Madoff would recognize the significance of "red flags" (e.g., would know to ask questions about the independence of the auditor)?

This seemingly massive failure of sophisticated investors to leverage their financial expertise and wealth to ferret out material information on Madoff's investment program suggests that continued reliance on sophisticated investor status as a basis for exemption from Securities Act registration may be misplaced as a legislative policy matter because it appears that many of Madoff's sophisticated investors either were unable or unwilling *to fend for themselves*.[240]

B. Investors Who Peered Beneath the Surface

Sophisticated investors were not uniform in their regard for Madoff's program, and Markopolos reportedly was not alone in his distrust of Madoff's strategy. In one instance, a hedge fund manager who sat on the board of a charity reportedly convinced fellow trustees to withdraw the charity's investment from Madoff's program when his staff could not replicate Madoff's strategy.[241] The OIG noted that several private parties who conducted diligence on Madoff's program ultimately determined not to invest with Madoff after their diligence "revealed numerous and significant red flags and concerns."[242] These parties generally focused on fairly basic documentation, such as

missed red flags billowing over Mr[.] Madoff's business, such as the way he kept custody over his clients' accounts, handled the trades himself and employed an obscure accounting firm. They ignored warnings from lesser mortals, such as one in 2001 from MAR/Hedge, a diligent trade journal. They never wondered why, though the sums he managed were vast, he rarely caused a ripple in the markets.").

239. *See Arvelund*, *supra* note 214, at 26.

240. Some potential investors examining Madoff's program more likely smelled not the sweetness of a rose. *See* WILLIAM SHAKESPEARE, ROMEO AND JULIETTE act 2, sc. 2 ("What's in a name? That which we call a rose By any other name would smell as sweet."); *see* Zuckerman & Gauthier-Villars, *supra* note 208, at C3 ("[Harry] Markopolos says he told [certain investors] that he thought Mr. Madoff was a fraud. He regrets he could not persuade many of them."); Masters, *supra* note 49 ("Two fellow trustees of an educational institution where [Madoff] sat on the board say they had long had reservations about his reported returns. However, they did not speak up and made no effort to prevent the school from investing with him. 'I thought he might be front-running [a form of insider dealing involving trade placed right before big orders] or something dubious like that—I never would have thought he was just inventing the whole thing,' says one.").

241. *See* Masters, *supra* note 49.

242. SEC, *supra* note 114, at 412.

financial statements and trading records, and considered concepts like independence and transparency.[243] According to one investment-advisory-firm official whose firm conducted diligence on Madoff for numerous clients, "there was a preponderance of suspicion among hedge fund industry insiders that something was awry at Madoff Securities."[244]

Madoff's consistent investment returns strained credulity of a fund of funds official with extensive options' experience because "[y]ou can construct [an options] strategy . . . where you'll make money most of the time but you cannot construct a strategy where you make money all of the time."[245]

C. Diligence on Private Offerings

There is no definitive data on the size of the U.S. private offering market or on the size of Regulation D offerings, according to the Office of Inspector General.[246] However, the OIG estimated the size of the Regulation D market for 2008 at $609 billion.[247] The OIG also observed that small issuers reported $1.2 trillion of unregistered securities offerings in the period of January 2000 to March 2001.[248]

---

243. *Id.*

244. *Id.* This firm employed an "iterative multi-phased" approach to due diligence, in contrast to a "check-the-box" methodology, and interviewed people at all levels of the fund. *Id.*

245. *Id.* at 414. This official's firm also compared a sample of trades with activity in the market, and noticed that "the purchases were at or close to the lows of the day, and the sales were at or close to the highs of the day"—a virtual impossibility. *Id.*

246. SEC, Office of Inspector General, Report No. 459, Regulation D Exemption Process 2 n.18 (2009).

247. *Id.* at 2. OIG's estimate was based on the "average capital amount" sought to be raised by issuers who filed 323 electronic Regulation D filings between September 15, 2008, and December 31, 2008. The average capital amount was then multiplied by the total number of Regulation D filings in 2008. According to Thomson Reuters, approximately $4.134 trillion in proceeds were raised in private offerings of securities from 2005 through the first half of 2009. *Archives Quarterly Reviews,* Thomson Reuters, http://online.thomsonreuters.com/DealsIntelligence/ReviewsAndAnalysis/ArchiveQuarterlyReviews (last visited Jan 6, 2011) (create account; access Debt & Equity US Private Placement Review Table AL1 Overall Private Placements for 4Q 2006, 4Q 2007, 4Q 2008, 2Q 2009; contact analyst for 4Q 2005) (data gathered from a survey of Bank of America Merrill Lynch, Barclays Capital, JP Morgan, Goldman Sachs & Co., and other lead agents). In contrast, $699 billion of securities were registered with the Commission during fiscal years 2005–2009 (the government's fiscal year ends September 30th). 2009 U.S. Sec. & Exch. Comm'n Performance and Accountability Report at 42 fig.2.23 (2009), *available at* http://sec.gov/about/secpar2009.shtml.

248. SEC, *supra* note 246, at 3 & n.19.

As noted earlier, about $25 billion of "worthless securities" were offered in the period 1919–1929,[249] which would be worth approximately $3.5 trillion in 2008.[250] If one compares the average of $2.5 billion for one year during the decade preceding the 1929 Stock Market Crash, the resulting amounts in 2008 would be $348 billion,[251] or a little over one half of the estimated $609 billion of Regulation D offerings for 2008.[252]

Looking beyond the Madoff offerings to the broader private offering market, is the type of diligence reportedly conducted by certain Madoff investors typical for sophisticated investors—particularly institutional investors—in evaluating their initial investment and continuing participation in private offerings generally?[253] Or did this episode represent just an aberration, a momentary lapse in discipline that is unlikely to be repeated? Are the financial thresholds for individual accredited investor status a meaningful gauge of the individual's sophistication for Rule 506 or the private-offering exemption afforded by Section 4(2), which is the underlying statutory authority for the Rule? If sophisticated investors lack the discipline, the ability, or the power to perform something other than cursory diligence, do the policy bases for the Section 4(2) exemption have any continuing validity? In other words, does an exemption that originally reflected a legislative judgment that sophisticated investors do not have *any practical need* for the protections of registration—or that the *benefits of registration would be too remote*—continue to justify a policy choice that federal government resources should not be devoted to reviewing private offering documents for adequacy of disclosure? Ultimately, are sophisticated investors implicitly relying on the government to protect them as a "backstop" to their otherwise cursory diligence?

D. *Factors that Impact Decision-Making*

Among Madoff's individual investors were retirees, celebrities, and widows.[254] The financial sophistication of these individual investors generally is a far cry from the ranks of some market professionals—such as hedge fund managers, executives and economists of

249. H.R. REP. NO. 85, at 2 (1933).

250. *Six Ways to Compute the Relative Value of a U.S. Dollar Amount, 1774 to Present*, *supra* note 61 (calculated based on the relative share of Gross Domestic Product).

251. *Id.*

252. SEC, OFFICE OF AUDITS, REPORT NO. 450, REGULATION D EXEMPTION PROCESS v (2009).

253. *See* supra notes 208, 213–15 and accompanying text.

254. *See supra* notes 59, 63–65 and accompanying text.

prominent financial services firms, etc.—who also reportedly were among Madoff's investors.[255] In this instance, market professionals—both those who invested personal funds and those who invested their clients' funds—seemingly fared no better than individual investors (some of whom probably were accredited investors) who generally lack the sophistication of professionals in evaluating investment products and executing trading strategies.[256] Nonetheless, when investment vehicles like Long Term Capital Management[257] implode, or investment scams like Madoff's Ponzi scheme collapse, the public disclosure of sophisticated money managers and investors (the "smart-money") among the ruins tends to expose sophisticated investors' decision-making and financial acumen to external scrutiny.[258]

Irrespective of whether investors are sophisticated or not, investors' decisions typically are influenced by factors other than purely technical knowledge and analysis of facts related to particular investment instruments or opportunities.[259] While it is expected that sophisticated investors will seek to advance their particular interests, the rationality of their investment decisions[260] often is subject to biases that affect individual choices.[261] Moreover, as some Madoff

255. *See* Madoff's Victims, *supra* note 11.

256. *See, e.g.*, *id.*; *see also* Jason Zweig, *Where Ezra Merkin Lost His Way*, WALL ST. J., Jan. 10, 2009, at B1. The Ascot Partners hedge fund, for example, invested nearly all of its $1.8 billion in assets with Madoff. *Id.*; *see also* Searcey & Efrati, *supra* note 48, at A1 (stay-at-home mother in Tampa, Florida, lost "her children's nest egg").

257. Mitchell Pacelle & Anita Raghavan, *Long-Term Capital Investors, Lenders Demand Answers*, WALL ST. J., Sept. 25, 1998, at A8.

258. This skepticism about the quality of sophisticated investors' decision-making recurs periodically. *See, e.g.*, Langevoort, *supra* note 195, at 1061 ("Does what we know about the behavior of institutional investment managers suggest that they act consistently in the diligent, rational manner we would expect from educated, highly-incentivized people who are engaged in repeat-play activities?").

259. *See* Martin Sewell, Behavioural Finance, 1 (Apr. 2010) (unpublished manuscript), http:\\behaviouralfinance.net/behavioural-finance.pdf ("Behavioural finance . . . helps explain *why* and *how* markets might be inefficient.").

260. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 3 (7th ed. 2007) ("Behavior is rational when it conforms to the model of rational choice, whatever the state of mind of the chooser.").

261. These biases, which reflect "*systematic* departures from rationality," include the sunk costs fallacy, the endowment effect, and hyperbolic discounting. *Id.* at 17; Langevoort, *supra* note 195, at 1046 (asking whether the Commission's mission should include "debiasing" investors). One convicted fraudster observed that some investors are susceptible to appeals to their desire to do the deal, almost to the point of an "addiction." Glenn Ruffenach, *Encore (A Special Report)—Confessions of a Scam*

investors seemingly demonstrated, a marquee name may be all the comfort some investors seek.[262]

Finally, investors' decisions often are heavily influenced by the level of trust they repose in persons or parties to the proposed transaction and in securities markets generally.[263] Although trust is

---

Artist, WALL ST. J., Aug. 9, 2004, at R1 (stating that these "personality traits" typically are exhibited by individuals in their 50s and wealthy entrepreneurs).

262. *See* Romy Vargese & Kellie Geressy–Nilsen, *Investors Tap Berkshire, Kraft*, WALL ST. J., Feb. 4, 2010, at C7 ("'For many investors, knowing that Warren Buffett is behind the offering is about all the research he or she may need to do when considering this deal,' according to Margie Patel, a senior portfolio manager at Evergreen Investments . . . ."). Debt holders and shareholders do not share mutuality of interests, given the priority that debt holders have upon any liquidation of the company. Thus, as the company's lenders, debt holders' diligence necessarily must extend beyond the *name*, as they seek to determine what covenants and other contractual restrictions (if any) would be appropriate for the risk they have assumed in the purchase of an issuer's debt securities. Mr. Buffet wants new shareholders and "Berkshire veterans" alike to "understand Berkshire's operations, goals, limitations, and culture," and encourages shareholders to read "the economic principles that guide [Charlie Munger and him]." Letter from Warren E. Buffet, Chairman of the Bd., Berkshire Hathaway Inc., to Shareholders of Berkshire Hathaway Inc. 3 (Feb. 26, 2010), *available at* http://www.berkshirehathaway.com/letters/2009ltr.pdf; *see also* WARREN E. BUFFET, AN OWNER'S MANUAL (2010), *available at* http://www.berkshirehathaway.com/ownman.pdf. Debt holders, likewise, would be well-served to conduct proper diligence in accordance with their economic interests. In this instance, the indenture for the senior unsecured debt securities did not provide for significant restrictions on Berkshire's activities or operations. *See* BERKSHIRE HATHAWAY INC. & BERKSHIRE HATHAWAY FINANCE CORP., SECURITIES REGISTRATION STATEMENT (FORM S-3), exhibit 4.1, at 13 (Feb. 1, 2010), *available at* http://www.sec.gov/Archives/edgar/data/1067983/000119312510017756/dex41.htm. While Letters to Shareholders and the "owners' manual" offer insight into Berkshire management's philosophy and practices, debt holders ultimately can enforce only those particular rights and restrictions set forth in the indenture, which forms their contract with the obligor(s) on the debt securities. Felicia Smith, *Applicability of the Securities Act of 1933 and the Trust Indenture Act of 1939 to Consent Solicitations to Amend Trust Indentures*, 35 HOW. L.J. 343, 345 (1992) ("[I]f one lesson can be drawn from the RJR scenario, it is that bondholders enjoy no greater rights or protections than those specifically enumerated by the terms of the trust indenture under which the bonds were issued. . . . This is not a new lesson, but one that has tended to be overlooked by investors in investment-grade debt.").

263. President Roosevelt stressed a need to restore investor confidence as a reason for the legislation that eventually was enacted as the Securities Act. H.R. DOC. NO. 73-12, at 1 (1933) ("It should give impetus to honest dealing in securities and thereby bring back public confidence."); *see also* Claire A. Hill & Erin Ann O'Hara, *A Cognitive Theory of Trust*, 84 WASH. U. L. REV. 1717, 1754 (2006) ("[W]here the law seeks to encourage trust, it does so by reducing the risk to parties of trusting one another sufficiently that they are willing to expose themselves to some level of vulnerability . . . . [But] where more careful assessments are desirable, as parties interact more, they

an indispensable factor in U.S. securities trading markets, it is neither indiscriminate nor blind. For example, U.S. daily trading volume on the New York Stock Exchange was 2.3 billion shares in 2008.[264] Modern securities trading markets function effectively because the trust that makes them possible is undergirded with a regulatory infrastructure that protects the legitimate expectations of the parties that each will obtain the benefit of the bargain: namely that the buyer will tender the cash consideration and the seller will tender the quantity of common stock or other securities, respectively, at the contract price on the date the trade is required to be completed.[265] This largely anonymous market transaction—in that buyer and seller are unlikely to know the identity of the other—processed by any number of intermediaries (brokers, dealers, securities exchanges, or clearing firms) also is highly regulated and transparent, and the risk of failures to settle trades is not a significant problem.[266] Consequently, the seller will not receive payment for securities that are not delivered, and the buyer will not receive securities for which full payment is not made.[267]

However, this trust does not necessarily translate to the largely unregulated contractual relationships that underlie private placements. In those settings, the sophisticated investor can bargain for the level of information (or disclosure) he considers appropriate both for his initial investment decision as well as that which would be acceptable as long as he is an investor.[268] If the issuer is a public reporting entity, the investor also can avail himself of the annual, periodical, and current public disclosure reports mandated by the Securities Act, which generally requires disclosure of important

acquire more trust-relevant information, determining for themselves optimal levels of specific trust and distrust.").

264. NYSE EURONEXT, ANNUAL REPORT, FORM 10-K, at 4 (Feb. 27, 2009), *available at* http://ir.nyse.com/phoenix.zhtml?c=129145&p=irol-reportsAnnual.

265. *See generally* 15 U.S.C. §§ 78k, 78k-1, 78q-1 (2006); 17 C.F.R. §§ 242.600-12; Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future*, 51 DUKE L.J. 1397, 1500–02 (2002) (arguing that securities market is efficient because "legal sanctions support a vital process of trust building").

266. According to data from The Depository Trust & Clearing Corporation, since 2005 at least 98% of transaction dollars were settled on time. SEC, *supra* note 246, at 40 fig.2.20.

267. JOHN DOWNES & JORDAN ELLIOT GOODMAN, BARRON'S FINANCE & INVESTMENT HANDBOOK 401 (7th ed. 2007).

268. Prentice, *supra* note 265, at 1444 (stating that sophisticated investors can choose to "bargain for lots of information, some information, or no information").

information on the issuer's business activities, financial position, and management.[269] However, in the absence of an issuer's obligation to make public disclosure, the investor's ability to obtain material information on his investment with some regularity (whether quarterly, annually, or both), or upon specified events, becomes more critical.[270]

To the extent sophisticated investors substitute trust for diligence, they should bear the risks—including loss of investment principal—associated with their decisions. Indeed, there are instances where mutual convenience or course of dealing may obviate concerns about potential losses to institutional investors due to failure to conduct diligence among contra-parties who operate on the level of mutual trust.[271] In these instances, the party from whom a make-whole payment—or "restitution"—is sought, is thought to so value the *relationship* that it would be reluctant to favor its perceived short-term advantage over the long-term consequences of litigation,

---

269. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78m(a), 78o(d) (2006)).

270. *See* Wulf A. Kaal, *Hedge Fund Valuation: Retailization, Regulation, and Investor Suitability*, 28 REV. BANKING & FIN. L. 581, 593 (2009).

271. For example, notwithstanding the potential for inaccurate hedge fund valuations (including the inherent risk that managers may misprice fund units), qualified investors and fund managers can avail themselves of "informal rules and business practices" that place a premium on maintaining relationships and protecting business practices. *Id.* at 624–25. Even with patent conflicts between the parties, the informal "course of dealing" rules are not a novel response to disputes with certain capital markets participants, but also predated the Securities Act. In his testimony before the Senate Committee on Banking and Currency, Mr. J.P. Morgan described his firm's business strategy:

> MR. PECORA. But the interests of your firm would be best served by doing the financing in the safest possible way and for the greatest amount of profit or commission, would it not?
>
> MR. MORGAN. No; it should not. Certainly not. You seem to think we do not want to go on doing business. We do want to go on doing business.
>
> MR. PECORA. You want to go on doing business profitable to yourselves?
>
> MR. MORGAN. Not only profitable to ourselves, but you cannot go on with any good business that only one side makes any money on.

Stock Exchange Practices: Hearing on S. Res. 84 and S. Res. 56 Before the S. Comm. on Banking and Currency, 73d Cong., pt. 1, 57 (1933) [hereinafter *Pecora Committee Hearings*]. Nonetheless, because of its expertise in business matters, the sophisticated investor's "duty to investigate the facts surrounding a securities transaction" exceeds that of the "novice." C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1092 (Dec. 1988).

tarnished reputation, or—worse still—the loss of a significant business relationship.[272] So in this sense, the choice of a sophisticated investor who substitutes trust for diligence may be rational; however, this investor also has to accept the financial risk that a relationship that seemed so stable may in a particular situation (e.g., market turmoil or the replacement of personnel who have a vested interest in the relationship) be viewed as expendable by its contra-party.[273] Notwithstanding the desire to substitute *trust* for customary diligence of investment products and offerings, individual accredited investors, unlike sophisticated investors, may not have the same investment expertise or ability to withstand losses of investment principal or access to those "informal rules and business practices" favored by institutional investors.[274]

E. Accreditation as a Substitute for that "Special Relationship"

To what extent is accreditation a proper substitute for that special relationship with—or special knowledge of—the issuer that marks the sophisticated investor? Although the safe harbor of Rule 506 permits issuers—or promoters—to qualify those investors who may participate in private offerings, the accredited investor—whether acting individually or with the assistance of a purchaser representative—may or may not be sophisticated, particularly if the investor is not an angel investor,[275] venture capitalist, controlling shareholder, director or officer of the issuer, or if the investor lacks the leverage and capacity to bargain for access to information the investor deems relevant concerning the investment and the capacity to evaluate that information.[276]

272. *See* Kaal, *supra* note 270, at 624–25.

273. *Id.*; Henry Jarecki & Jason Ungar, *Doing Your Due Diligence*, FUTURES, July 2009, at 38, 39, 42.

274. Kaal, *supra* note 270, at 624–25.

275. The angel investor typically is a wealthy individual who finances new business ventures by providing additional seed and start-up capital to the entity. Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1406 (2008); Eugene Choo, *Going Dutch: The Google IPO*, 20 BERKELEY TECH. L.J. 405, 409 (2005). In contrast, the venture capitalist provides financing at a later stage of the entity's development. *Id.*

276. *See* Doran v. Petroleum Mgmt., 545 F.2d 893, 904–05 (5th Cir. 1977) (noting that the issuer's reliance on an offeree's investment sophistication depends on whether the offeree "could have been expected to ask the right questions and seek out the relevant information"); United States v. Hill, 298 F. Supp. 1221, 1228 (D. Conn. 1969) ("No investor can be said to be sophisticated *per se*; he can only fend for himself when he

By comparison, investors in putative private offerings in the period prior to enactment of the Securities Act may not have been "financially sophisticated" either.[277] Many investment bankers maintained lists of preferred investors for private offerings of common stock during the boom years of 1928 and 1929,[278] which typically included "officers and directors of banks, trust companies, insurance companies and other great financial institutions, executives of railroads, utilities, and industrial corporations, editors, lawyers, politicians, and public officials."[279] For example, J.P. Morgan & Co. purchased securities issued by the United Corporation, Alleghany Corporation, Standard Brands, Johns-Manville Corporation, and Niagara-Hudson Power Corporation, and distributed a portion of those securities to "influential" investors on Morgan's preferred lists,[280] which included persons who held "prominent governmental, political, and corporate positions."[281]

Mr. George Whitney, a J.P. Morgan partner, described the purpose of the "preferred" lists as a means for Morgan to share the risks of equity securities distributions with other "underwriters,"[282] a method

---

has personal knowledge of or has access to the kind of information which a registration statement would disclose.").

277. *See infra* note 278 and accompanying text; *see also infra* notes 280–90 and accompanying text.

278. *Pecora Committee Hearings*, *supra* note 271, pt. 2, at 401 (statement of Mr. George Whitney, J.P. Morgan & Co.) ("[T]here [had] been minor instances and very few opportunities to finance corporations by stock issuances prior to 1927.").

279. COMM. ON BANKING & CURRENCY, STOCK EXCHANGE PRACTICES, S. REP. NO. 73-1455, at 110 (1934), *available at* http://fraser.stlouisfed.org/publications/sensep/issue/3912/download/59691/19330606_sensep_rpt.pdf.

280. *Id.* at 101, 106–07 (stating that Drexel & Co., Kuhn, Loeb & Co., and National City Co. maintained similar lists for securities distributions). *Pecora Committee Hearings*, *supra* note 271, at 855 (statement of George Whitney, J.P. Morgan & Co.) ("[T]hose who were on the preferred list were either wealthy and in the investing class or . . . they were friends of the House of Morgan or its representatives.").

281. S. REP. NO. 73-1455, at 101; *see generally Pecora Committee Hearings*, *supra* note 271 (testimony describing the buying and selling of securities). In one transaction, Morgan acquired Alleghany Corporation common stock for $20 per share, and sold a portion of the shares to its preferred list purchasers at its cost—*i.e.*, $20 per share. S. REP. NO. 73-1455, at 101. Morgan's preferred list purchasers of the Alleghany stock included the Chairman of the National Democratic Committee, Treasurer of the Republican National Committee, Secretary of the Navy, Speaker of the New York State Assembly and State Chairman of the Republican Party, President of the United States Chamber of Commerce, President of the American Bar Association, and President of American Car & Foundry Co., and later Secretary of the Treasury. *Id.* at 102.

282. *Pecora Committee Hearings*, *supra* note 271, at 396–97 (statement of George Whitney, J.P. Morgan & Co.) ("But we did believe that we knew certain people who

of using individuals to distribute securities that historically developed in London.[283] While these transactions nominally were effected as private placements, they seemed to transform into de facto public offerings.[284] Investment bankers and the investors on the preferred lists profited handsomely from the resales of their securities to public investors at prices that reflected the "intense public interest" generated by the "considerable publicity" surrounding these private placements.[285]

Preferred-list participants exemplified the type of investors who could fend for themselves in securities distributions prior to adoption of the Securities Act.[286] The preferred-list participants may or may not have been financially sophisticated, but their investment banking "sponsors" had incentives not to place their "preferred" investors in

had the substantial wealth, the knowledge of their securities, and the willingness to take a risk along with us in the underwriting of these common stocks."). Mr. John Pierpoint Morgan stated that his firm's principal securities business was dealing in bonds, not common stock. *Id.* at 879 (statement of J.P. Morgan, head of J.P. Morgan & Co.). Thus, consistent with its focus on "dealing in investment securities of established character," Morgan limited its common stock offerings to "individuals capable of sharing and understanding the risks," thereby avoiding common stock distributions to the general public, which were likely to occur if Morgan had invited other banks and dealers to participate in the distribution. *Id.* at 880 (statement of J.P. Morgan, head of J.P. Morgan & Co.).

283. *Id.* at 401 (statement of George Whitney, J.P. Morgan & Co.) ("They take a risk of profit; they take a risk of loss. In either event we believe that they are competent to take the risk, in whichever form it may be, based upon their knowledge and their own opinion and their own judgment.").

284. *See* S. REP. NO. 73-1455, at 101.

285. *Id.* As a result of the immense publicity, "market levels materially above the price of the original offering were quickly established." *Id.*

286. *See supra* notes 280–81 and accompanying text. According to Lewis Corey's *The House of Morgan*, it was estimated that J.P. Morgan "influence[d] about $74,000,000,000 of corporate wealth" through interlocking directorates (representing about one quarter of the nation's corporate assets). *Pecora Committee Hearings*, *supra* note 271, at 847 (statement of Sen. Edward P. Costigan). The Senate committee focused, in part, on banks that used preferred lists and interlocking directorates to enhance their influence over corporate wealth, and the resulting failure of recipients of those favors (i.e., corporate officers and public officials) to exercise their responsibilities to their institutions or the public, respectively. *See* S. REP. No. 73-1455, at 110. Although the Pecora Commission Report noted the pervasive presence of interlocking directorships and viewed those relationships as adverse to the public interest, the power of board members may have been overstated. Thomas K. McCraw, PROPHETS OF REGULATION 114 (1984) ("Interlocking directorates often reflected the insensitivity and power of top corporate managers (who selected most board members themselves) more than it did the power of the bankers, lawyers, and outside businessmen who sat on boards.").

unprofitable (or losing) investments.[287] In his response to Senator James Couzens's assertion that J.P. Morgan & Co. gave favorable prices to investors on the preferred list "so that they would reciprocate and keep on good terms,"[288] Mr. Whitney ultimately conceded that he had "denied perhaps too vehemently . . . that we expected to get direct consideration."[289] Thus, while some of the preferred-list participants likely were merely "friends" of bankers at a particular investment banking firm—rather than captains of finance or industry—they probably had a high degree of confidence that their investment-banking sponsors would take care of them.[290] With their natural advantage relative to ordinary public investors[291] and the need for the investment bankers to maintain favorable business or personal relationships, preferred-list investors certainly could fend for themselves. Thus, by virtue of their placement on preferred lists maintained by their investment-banking sponsors, these preferred-list investors undoubtedly enjoyed a *special relationship*.[292] When individual investors who qualify as accredited investors for Rule 506 private offerings lack substantial wealth, knowledge of investments, and understanding of—as well as the ability to share—the risks of the private offering, it is questionable whether accreditation is an appropriate substitute for that special relationship that historically marked the private-offering exemption afforded by Section 4(2).[293]

---

287. *See* S. REP. NO. 73-1455, at 109–10 (asserting that "preferred lists" were among the means that investment bankers used to "extend their influence and control over" persons who were prominent in finance, industry, and politics).
288. *Id.* at 105–06 (stating that according to Senator Couzens, "direct consideration" from preferred list investors included "making deposits with your concern, . . . giving you their underwritings, and the opportunity to sell their securities").
289. *Id.* at 106. Mr. Otto H. Kahn testified that Kuhn, Loeb used its preferred lists to "maintain the good will of individuals upon whom [it] relied for advice in financial matters," although he acknowledged that his firm ordinarily did not follow that advice. *Id.*
290. *Id.* at 205–07.
291. After enactment of the Securities Act, the ability to conduct stealth public offerings was substantially diminished as a result of the requirement to register offerings made by means of the mails or any instrumentality of interstate commerce (unless the transaction or securities met specified exemptions), and comply with disclosure mandates for the offering prospectus. *See* 15 U.S.C. §§ 77(e), 77(j) (2006). Given the perspective that preferred list participants essentially were helping to *underwrite* securities offerings, Section 4(1) precluded resales of securities acquired in a private offering by an issuer, underwriter, or dealer. 15 U.S.C. § 77d(1).
292. *See supra* note 182 and accompanying text.
293. *See supra* text accompanying notes 275–91.

F. Many Individual Investors Favored the Status Quo

More recently, the Commission sought to address the appropriateness of continuing to rely on largely unchanged income and net-worth financial tests for individuals seeking to invest in private offerings of hedge funds and similar pooled investment vehicles.[294] Noting that the standards originally adopted in the early 1980s served as an objective gauge for identifying that class of individual investors who were capable of evaluating and bearing investment risks of private offerings, the Commission observed that those standards may no longer meet their intended purpose, particularly given the effects of inflation, the "sustained growth in wealth and income of the 1990s," and the appreciation in home values—all of which have contributed to a substantial increase in the number of accredited investors.[295] The Commission questioned the ability of this expanded class of accredited investors to understand the complexity and risks of privately offered pooled investment vehicles, including the lack of publicly available information about the investment, undisclosed conflicting interests, complex fee arrangements, and higher risk structure.[296]

294. Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Securities Act Release No. 33-8766, [2006–2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,736 (Dec. 27, 2006) [hereinafter Release No. 33-8766], *available at* http://www.sec.gov/rules/proposed/2006/33-8766.pdf; *see also* Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. Rev. 733, 733 (2009) (noting the anomaly that wealthy heiress Paris Hilton who has no discernible financial expertise qualifies as an accredited investor but a Harvard MBA alumna with a Ph.D. in financial systems analysis cannot qualify because she does not meet the minimum income or net-worth tests).

295. Release No. 33-8766, *supra* note 294, at 84,047.

296. *Id.* The Commission sought to align the investor protections for offerings made under Section 3(c)(1) of the Investment Company Act of 1940 with those already available for offerings made under Section 3(c)(7) of the Company Act, which also require that each individual accredited investor own at least $5 million of investments upon his original investment in the pool. *Id.*; *see also* Edward Siedle, *Wealthy Still Suckers for Madoff-Style Scams,* FORBES*,* Mar. 17, 2010 12:00 PM, http://forbes.com/2010/03/17/madoff-wealthy-investors-personal-finance-affinity-fraud.html (stating that wealthy investors should seek money managers who will discuss "questions about manager compensation, fiduciary duty, conflicts of interest, custody of assets, hidden financial arrangements, pay-to-play, performance reporting and discrepancies, auditing practices, transparency and regulatory loopholes. Many wealthy investors haven't a clue about how insidious these issues can become if not dealt with head-on.").

The Commission initially proposed new Rule 509 of Regulation D, which would add a new category of accredited investor: the accredited natural person.[297] This new category of the accredited investor was intended "to help ensure that investors in [hedge funds and similar pooled investment vehicles][298] are capable of evaluating and bearing the risks of their investments."[299] As proposed, an accredited natural person must meet the income or net worth test of Rule 501(a), as well as own a minimum of $2.5 million in specified categories of investments[300] at the time of his initial investment in the pooled investment vehicle.[301] The "investments-owned" test may be satisfied individually or in the aggregate with the investor's spouse, and the dollar amount would be subject to periodic adjustments to reflect inflation.[302]

The release largely attracted comments in opposition to the proposed accredited natural person definition, although some persons supported the revisions.[303] Of those individuals who objected to the

297. Release No. 33-8766, supra note 294, at 84,047–48.

298. The Commission did not propose to include venture-capital funds within the ambit of the revisions. *Id.* at 84,051.

299. *Id.* at 84,042. The Commission acknowledged that the goal of its accredited natural person standard would be met if the individual were able to hire a professional advisor who had the requisite expertise "to evaluate the merits and risks of a prospective investment." *Id.* at 84,048.

300. *Id.* at 84,048. The Commission did not view increases in personal wealth due to appreciation in the valuation of real estate used by an individual (or certain family members) as a personal residence, or as a place of business, or in connection with a trade or business as indicative of the individual's investment "knowledge and financial sophistication." Accordingly, those assets were proposed to be excluded under the investments-owned test. *Id.* at 84,051.

301. *Id.* at 84,048. Proposed Rule 216 would have made similar changes to the definition of accredited investors for purposes of offerings of private-investment vehicles under Section 4(6) of the Securities Act. Solely for purposes of proposed Rule 509(a), an issuer can comply with the requirement if it "reasonably believes" that the individual satisfies the accredited natural person standard. *Id.* at 84,047–48.

302. *Id.* at 84,048. Over 600 comments on the proposals were filed with the Commission. Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 8828, [2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,939, 85,174 (Aug. 3, 2007).

303. *See Comments of James R. Sweeney*, SEC. & EXCH. COMM'N (Jan. 26, 2007), http://sec.gov/comments/s7-25-06/jrsweeney5331.htm ("[T]he proposed legislation . . . could save many inexperienced and trusting investors many millions of dollars."); *Comments of Kevin J. Koons*, SEC. & EXCH. COMM'N (Jan. 28, 2007), http://sec.gov/comments/s7-25-06/kjkoons3586.htm ("Experience and sophistication should require lower levels of protection such as a total net worth of at least $1,500,000. Lack of experience and sophistication should require higher levels of protection such as a total net worth of at least $3,000,000."); *Comments of Poor But Educated*, SEC. & EXCH. COMM'N (Jan. 29, 2007), http://sec.gov/comments/s7-25-

proposals, they tended to consider the revisions an infringement on personal liberty and freedom of contract, and sought to retain for themselves the autonomy to choose to participate in privately offered hedge funds and similar vehicles without further regulatory hindrance.[304] Still others questioned the premise that linked numerical standards, such as net worth, as a valid proxy for financial acumen[305] and viewed the proposals as favoring the wealthy.[306]

06/peducated5730.htm (supporting an examination requirement to establish the requisite financial sophistication for those who would not meet the proposed investments-owned test); *Comments of Gary R. Greenbaum, CFA, CAIA*, SEC. & EXCH. COMM'N (Feb. 1, 2007), http://sec.gov/comments/s7-25-06/grgreenbaum5173.htm (suggesting an exemption "from the proposed $2.5 million asset requirement" for those individual accredited investors who also have a personal financial plan, and have engaged a professional advisor who adheres to fiduciary standards and holds recognized investment credentials (e.g., CFA designation)).

304. *See Comments of William Tarallo*, SEC. & EXCH. COMM'N (Jan. 4, 2007), http://sec.gov/comments/s7-25-06/wtarallo3592.htm ("[A]n effort to disenfranchise the INDIVIDUAL INVESTOR [sic] from the fruits and influence of modern finance"); *Comments of Janell C. Rhee*, SEC. & EXCH. COMM'N (Jan. 9, 2007), http://sec.gov/comments/s7-25-06/s72506.shtml (An "educated hedge fund investor" who would not meet the new accreditation standard expressed "alarm[], concern[] and [anger] that [the Commission] consider[ed] [her] too ignorant [and] uneducated" to invest in pooled investment vehicles); *Comments of Michael E. Guerra, M.D.*, SEC. & EXCH. COMM'N (Jan. 26, 2007), http://sec.gov/comments/s7-25-06/meguerra4152.htm ("It is paternalistic and immoral for government to prohibit freely entered into transactions . . . . Net worth is not determinant of critical thinking and keen analysis."); *Comments of Maco Stewart*, SEC. & EXCH. COMM'N (Jan. 26. 2007), http://sec.gov/comments/s7-25-06/s72506-20.htm ("Please consider the millions of us who understand what we invest in but are not rich. Discriminating against us is not right and is not in the public interest."); *Comments of Robert Moore*, SEC. & EXCH. COMM'N (Jan. 26, 2007), http://sec.gov/comments/s7-25-06/rmoore5020.htm ("Shouldn't I be free to lose all my money if I'm wrong or make lots of money if I'm right? . . . Whether I win or lose it's not the responsibility of government to protect me from my own stupidity; nor is it the responsibility of government to bail-me-out if I make a bad decision."); *Comments of Darrell Black*, SEC. & EXCH. COMM'N (Jan. 26, 2007), http://sec.gov/comments/s7-25-06/s72506-77.htm ("With the taxes a person has to pay today having an AGI of only $200,000.00, you can't really put much away anymore. I pay in excess of $70,000 per year in taxes. So, give us smaller net worth individuals an opportunity to 'grow.' We know the risks!"); *Comments of Robert Durden*, SEC. & EXCH. COMM'N (Jan. 29, 2007), http://sec.gov/comments/s7-25-06/rdurden3735.htm ("Similar to most government interference designed to 'provide additional investor protections', this proposed rule change is misguided and based on the false assumption that rational, self-interested adults are less capable of determining their financial well-being than a government committee.").

305. *See Comments of Craig A. Matson*, SEC. & EXCH. COMM'N (Jan. 18, 2007), http://sec.gov/comments/s7-25-06/s72506-14.htm (asserting that from his vantage point as a proprietary trader who is not an accredited investor, there is "no relationship

Several months later, the Commission proposed to update the definition of accredited investor[307] and to create the new category of

between net worth and financial savvy," given the experience of wealthy institutional and individual investors in the "Long Term Capital Management and Amaranth debacles"); *Comments of Daniel L. Gastel*, SEC. & EXCH. COMM'N (Jan. 27, 2007), http://sec.gov/comments/s7-25-06/dlgastel9430.htm ("There are many people sophisticated enough to understand the risks who do not meet the criterion, who have chosen to become teachers or social workers or something that doesn't pay well."); *Comments of Sebastian Good*, SEC. & EXCH. COMM'N (Jan. 27, 2007), http://sec.gov/comments/s7-25-06/sgood5517.htm ("Money can be achieved by work, by luck, by theft and any number of other measures. It does not always imply competence."); *Comments of Jack P. McCormick*, SEC. & EXCH. COMM'N (Jan. 28, 2007), http://sec.gov/comments/s7-25-06/jpmccormick1550.htm (suggesting a gradual increase in the net worth requirement with upward adjustments based on experience "over a representative period"); *Comments of Alan M. Gordon*, SEC. & EXCH. COMM'N (Jan. 31, 2007), http://sec.gov/comments/s7-25-06/amgordon4206.htm ("Due diligence is more important to success than just having had the moeny [sic] to invest in the first place; many wealthy people lose money all the time by investing in ideas that they have not checked out.").

306. *See Comments of Ross G. Kaminsky*, SEC. & EXCH. COMM'N (Dec. 30, 2006), http://sec.gov/comments/s7-25-06/rgkaminsky5279.htm ("The current accredited investor rules are already more than enough to ensure that the rich get richer and the rest have far fewer opportunities to catch up."); *Comments of Kevin Hoffmeyer*, SEC. & EXCH. COMM'N (Jan. 17, 2007), http://sec.gov/comments/s7-25-06/khoffmeyer9241.htm (stating that the proposed revision "will only help to perpetuate the wealth gap that exists in this country"); *Comments of Thomas Hardy, Adjunct Professor of Finance*, SEC. & EXCH. COMM'N (Jan. 26, 2007), http://sec.gov/comments/s7-25-06/thardy8631.htm ("As there tends to be a correlation between risk and return, in allowing only the wealthy to make certain higher-risk investments, you further increase the disparity between the wealthy and the middle class."); *Comments of Bruce H. Wilson*, SEC. & EXCH. COMM'N (Jan. 26, 2007), http://sec.gov/comments/s7-25-06/bhwilson7477.htm ("But let the public decide where they want to put their money without the artificial guidelines that eliminate 99% of the investing public based on criteria that allows only the super rich to avoid the 'buy and hope' mentality that is so common in relative return programs."); *Comments of Dr. Lanny Herron, Professor of Management*, SEC. & EXCH. COMM'N (Jan. 28, 2007), http://sec.gov/comments/s7-25-06/lherron9362.htm ("I can think of no one who benefits from such rules other than certain parties who wish to stifle competition."); *Comments of Tony Jackson*, SEC. & EXCH. COMM'N (Jan. 28, 2007), http://sec.gov/comments/s7-25-06/tjackson6772.htm ("I believe the explosion of investing information that is now available has increased the sophistication of investors everywhere."); *Comments of William Duffy*, SEC. & EXCH. COMM'N (Jan. 28, 2007), http://sec.gov/comments/s7-25-06/wduffy5856.htm ("The focus of future regulation should be to make sure there is an honest game on an even playing field, not to exclude certain classes of citizens.").

307. The Commission proposed an investments-owned test of $750,000 as an alternative to the current net-worth test, adjusted periodically for inflation. Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 8828 [2007 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,939, at 85,181–82 (Aug. 3, 2007).

large accredited investor[308] as part of its efforts to modernize the private- and limited-offering exemption rules of Regulation D while ensuring that the investors could fend for themselves, and thereby obviating any need for registration of the transaction.[309] Unlike the comments to the earlier rulemaking proposal, which seemed to be dominated by individual investors, these proposals drew far fewer comment letters.[310] The Commission did not enact any of the proposed revisions to its accredited investor standards and announced in December 2009 that it had withdrawn the revisions it proposed in August 2007.[311]

Legislation was subsequently enacted to address the net-worth test for individuals.[312] Section 413(a) directed the Commission to exclude the natural person's primary residence from the calculation of net worth for the initial four-year period following enactment of the Dodd-Frank Act.[313] The Commission was authorized to conduct a review of the accredited investor definition applicable to individuals[314] and adjust the definition "as the Commission may deem appropriate for the protection of investors, in the public interest, and in light of the economy."[315] Section 413(b)(2) directed the Commission to review periodically the accredited investor

---

However, the proposed investments-owned test excluded the value of real estate assets used as personal residences or places of business. This exclusion reflected the Commission's judgment that allowing only assets held for investment would provide a better measure of "an investor's need for the protections of registration under the Securities Act." *Id.* at 34. Notably, unlike the proposed accredited natural person standard, the imposition of the investments-owned test would not result in any significant change in the number of individual investors who could qualify as accredited investors. *Id.* at n.90.

308. *Id.* at 85,174.

309. *Id.* at 85,171. The Commission also solicited further comment on its proposed accredited natural person definition. *Id.* at 85,181.

310. *See generally Revisions of Limited Offering Exemptions in Regulation D*, SEC. & EXCH. COMM'N, http://www.sec.gov/comments/s7-18-07/s71807.shtml (last visited Jan. 6, 2011) (Public Comment File).

311. Regulatory Flexibility Agenda, Release No. 33-9082, 74 Fed. Reg. 64576, Item 581 (Dec. 7, 2009).

312. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413, 124 Stat. 1376, 1577–78 (2010).

313. § 413, 124 Stat. at 1577; *see also Question 179.01*, subsection in *Compliance & Disclosure Interpretations / Security Act Rules*, SEC. & EXCH. COMM'N, http://sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm (interpretation of Section 413(a)).

314. § 413(b)(1)(A), 124 Stat. at 1577–78.

315. § 413(b)(1)(B), 124 Stat. at 1578.

definition and make appropriate adjustments.[316] Within three years after enactment of the Dodd-Frank Act, the Comptroller General must study the criteria necessary to qualify as accredited investors and to invest in private funds, and file its report with the Senate Committee on Banking, Housing and Urban Affairs, and the House Committee on Financial Services.[317] Finally, Section 418 of the Dodd–Frank Act requires the Commission within one year after enactment (and on a five-year cycle thereafter) to adjust for inflation any dollar-amount test for the qualified client standard of Section 205(e) of the Advisers Act.[318]

Although some individuals opposed the higher thresholds for the accredited natural person definition, they urged the Commission to impose periodic disclosure obligations on pooled investment vehicles.[319] The point of the registration exemption, however, is that (a) the investors can—without direct government intervention—induce the issuer to furnish the disclosure (or transparency) that the investors require as a condition of their investment, or (b) lacking this ability, the investors understand and accept the risk of investing in an issuer that is not subject to reporting obligations comparable to those imposed on publicly held companies.[320] This dichotomy illustrates a misunderstanding of "accreditation." On one hand, individual investors who satisfy the minimum financial thresholds (i.e., net

316. § 413(b)(2), 124 Stat. at 1578.
317. § 415, 124 Stat. at 1578 (GAO Study).
318. 15 U.S.C. § 80b-5(e) (2010); § 418, 124 Stat. at 1579.
319. *See Comments of Peter Clark, Ph.D.*, SEC. & EXCH. COMM'N (Feb. 9, 2007), http://sec.gov/ comments/s7-25-06/pclark6245.htm ("find innovative approaches to increase hedge fund transparency"); *Comments of Jeffrey E. Kahler, CPA*, SEC. & EXCH. COMM'N (Feb. 12, 2007), http://sec.gov/comments/s7-25-06/jekahler6095.htm ("raise the standard for disclosure"); *Comments of Kimberly J. Wilson*, SEC. & EXCH. COMM'N (Feb. 13, 2007), http://sec.gov/comments/s7-25-06/kjwilson6168.htm ("require full financial disclosure on the people running the programs with monthly financial reporting"). The Dodd–Frank Act imposes registration generally on certain advisers to private funds (but not on advisers to venture capital funds), but much of the *transparency* resulting from information required to be made available to the Commission, and the Financial Stability Oversight Council may not necessarily be made public if the information is exempt from disclosure under the Freedom of Information Act. *See* 5 U.S.C. § 552 (2006); Restoring Financial Stability Act of 2010 § 404(b)(1), (b)(3)–(b)(10), 124 Stat. 1573–74; Pub. L. No. 111-257, 124 Stat. 2646–47 (2010) (striking provisions of § 929I(b) of the Dodd–Frank Act that might have the effect of expanding exemptions from public disclosure); *see also* 156 Cong. Rec. S7298 (daily ed. Sept. 21, 2010) (Statement of Mr. Leahy) ("When Congress enacted the FOIA exemptions in section 929I, we sought to ensure that the SEC had access to the information that the Commission needed to protect American investors—not to shield information from the public.").
320. Release No. 33-8766, *supra* note 294, at 84,046.

worth or income) but who are not wealthy should be allowed to participate in private offerings because they understand what they are doing and can pay "the price of admission." *They can fend for themselves*. But on the other hand, these same smaller individual investors have no practical way to obtain desired issuer disclosures on a going-forward basis without the considerable weight of the Commission's authority. *They cannot fend for themselves*.[321]

V. LOOKING FORWARD

There remains a justification for allowing issuers to raise capital in private transactions with investors who are capable of conducting business in private markets.[322] The private-offering exemption provides issuers flexibility to access that class of investors who are least likely to (a) be impaired by information asymmetry,[323] or (b) become a burden on the public fisc if they suffer unfavorable economic outcomes or total loss of investment principal (i.e., as their gains are private, any *losses* remain *private* and are not transformed into obligations borne generally by taxpayers).[324] Those sophisticated investors who choose not to perform diligence, or do not insist on continuing disclosure over the life of their investment but nonetheless invest in the offering, should be left to the outcomes—whether positive or negative—of their investment decisions. Thus, even when sophisticated investors seemingly fail to exercise critical judgment in the conduct of their pre- and post-transaction diligence or lack vigor in exercising their bargaining strength *vis-à-vis* the issuer, not only is there no practical need for registration, the public benefits of registration remain too remote.

It is very doubtful that individual investors in public offerings actually read the statutory prospectus prior to making any investment

321. *See supra* Part I.B. (discussing the impact of the Madoff-Ponzi scheme on the "average American").

322. *See* Marc I. Steinberg and Emmanuel U. Obi, *Examining the Pipeline: A Contemporary Assessment of Private Investments in Public Equity ("PIPEs")*, 11 U. PA. J. BUS. & EMP. L. 1, 11 (2008) ("Depending on the circumstances, invocation of a particular exemption may enable an issuer to raise the requisite capital while avoiding the costs generally attributable to public offerings."); William K. Sjostrom, Jr., *Relaxing The Ban: It's Time To Allow General Solicitation And Advertising In Exempt Offerings*, 32 FLA. ST. U. L. REV. 1, 5–6 (2004) ("[A]ngel investors contribute not only capital but also business experience, which many entrepreneurs consider to be just as valuable as the capital [investment]."); Ibrahim, *supra* note 275, at 1406–07 (noting that many entrepreneurs rely on financing from angels).

323. *See supra* note 197 and accompanying text.

324. *See* Langevoort, *supra* note 195.

decision.[325] Although these individual investors may fail to practice pre-purchase due diligence, at least investment professionals who bring public deals to market have an incentive to conduct due diligence,[326] and public investors benefit from their diligence. Moreover, for at least the first year, the issuer also would be required to comply with Securities Act reporting obligations.[327] Thus, the ability to fend for themselves should be measured not only by the individual accredited investors' capability to conduct pre-investment due diligence and negotiate offering terms, but also their ability to negotiate on-going issuer disclosure in markets that are not comparable to the public-company disclosure régime.

Beacon Advisors estimated the size of the mass affluent market at $6 trillion, which generally means these individuals have $100,000 to $1 million in assets—excluding real estate—available for investment.[328] Although about 54.5 million—or 47%—of U.S. households own equities or bonds,[329] comments on the Commission's proposal to adjust the qualifications for accredited investors suggest an intense desire by individual investors to continue to have opportunities to participate in privately offered securities.[330] These investors want to make choices about investment vehicles and

325. Indeed, the Securities Act does not require that investors have read the registration statement in order to manifest reliance when seeking damages for untrue statements or omissions that meet the materiality standard. Securities Act of 1933, 15 U.S.C. § 77k(a) (2006).

326. Underwriters may assert a due diligence defense to liability. 15 U.S.C. § 77k(b)(3)–(c).

327. 15 U.S.C. § 78o(d)(2006).

328. Glenn Rifkin, *Financial Advice for the 'Mass Affluent'*, N.Y. Times, Apr. 6, 2006, at C7, *available at* http://www.nytimes.com/2006/04/06/business/06sbiz.html?_r=1&pagewanted=print. It is likely that the mass affluent market includes individuals who currently meet the individual accredited investor standard.

329. Inv. Co. Inst. & Sec. Indus. and Fin. Mkts. Ass'n., Equity and Bond Ownership in America, 2008, at 7 (2008) (showing figures which represent a decline of 7.4 million since 2001). This report measured ownership of individual stocks and bonds, stock and bond mutual funds, hybrid mutual funds, exchange-traded funds, and variable annuities. *Id.*

330. *See generally Comments on Proposed Rule: Prohibition of Fraud by Advisors to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, Sec. & Exch. Comm'n, http://sec.gov/comments/s7-25-06/s72506.shtml (last visited Jan. 06, 2011). Although the Commission ultimately declined to act on these proposals, the Dodd–Frank Act requires the Commission to adjust the net worth standards for individual accredited investors, excluding the value of the investor's residence (for the first four years). Dodd–Frank Act, § 413, 124 Stat. at 1577; *see also* Dodd–Frank Act, § 415, 124 Stat. at 1578 (GAO Study). By contrast, the GAO Study would address "accredited investor status and eligibility to invest in private funds." Dodd–Frank Act § 415, 124 Stat. 1578.

allocation of personal investment resources rather than have regulators make those choices for them. After all, it is not clear that regulators, however well-intentioned, do not have similar biases that affect their decision-making.[331]

However, in light of statements submitted to Judge Chin by a number of Madoff's individual accredited investors, and views expressed by some of the individuals commenting on the Commission's accredited natural person proposal,[332] there should be systematic efforts to identify which categories of investors to whom Rule 506 offerings currently may be made actually can fend for themselves *throughout* the life of the particular private-offering investment. Since its adoption in 1982, there should be sufficient offerings that would enable researchers to conduct a thorough examination of how Rule 506 is used from the viewpoint of all participants in the offering process: issuers, individual and institutional investors, placement agents, and purchaser representatives.[333] Regulation D offerings should be scrutinized so that we understand the nature of the investors and the type of risk these investors have incurred. What is the nature of diligence on the offering conducted by placement agents, individual accredited investors, and purchaser representatives? In examining methods adopted by individual accredited investors, to what extent do they rely on professional advisors in identifying investment opportunities

331. *See* THOMAS SOWELL, BASIC ECONOMICS: A COMMON SENSE GUIDE TO THE ECONOMY 74–75 (3d ed. 2007) ("The mechanisms of the market are impersonal but the choices made by individuals are as personal as choices made anywhere else . . . . The real contrast is between choices made by individuals for themselves and choices made for them by others who presume to define what these individuals 'really' need."); Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551, 1575 (1998) ("The expert, too, is behavioral man. Behavioral man behaves in unpredictable ways. Dare we vest responsibility for curing irrationality in the irrational?").

332. *See supra* notes 58, 66–72, 303–06 and accompanying text.

333. Since registered brokers or dealers are required to maintain books and records for a minimum of three years and are subject to regulation by the Commission, their data should provide a significant sample from which to conduct research on a variety of offerings in a widely dispersed geographic area. *See* 17 C.F.R. § 240.17a–3 to a–4 (2010). In addition to public hearings, the Commission also should seek to elicit data directly from individual investors who participate in Rule 506 offerings and issuers who use the exemption in their capital raising activities. Unlike registered brokers or dealers, none of these persons are subject to regulation by the Commission; nonetheless, it would be important to consider the experiences of issuers and investors as part of the general examination of the Rule, and efforts should be made to encourage their participation (e.g., staff conducting hearings on a regional basis).

or making investment decisions? Do their respective purchaser representatives have expertise in the product or strategy that is the subject of the private offering? How are their purchaser representatives selected? Are their respective purchaser representatives compensated solely by the relevant accredited investor, or are the purchaser representatives relying on disclosure of their conflicts to their investor clientele?[334] What percentage of purchaser representatives work exclusively for their principal, the accredited investor, and have a compensation structure that is unrelated to particular transactions considered by their principal—i.e., the purchaser representative's compensation is not linked to whether the principal invests in private offerings that are scrutinized by the purchaser representative? What means do issuers use to conduct diligence on potential investors? What written or other disclosure ordinarily is furnished by issuers? What sales or marketing materials—if any—do issuers use with potential investors and professional advisors, including those who are associated persons of registered broker-dealers?

Do we forestall smaller affluent investors—those who meet the current minimum accredited investor thresholds—from investing in private placements because the investment is too risky for them? Do we continue to allow smaller affluent investors to determine the level of risk appropriate for their investment needs? How do we balance the interest of the smaller accredited investors to participate in private placements with those investors' "expectations" that the government is protecting them from the risk they have incurred? Are there significant risks associated with participation by the smaller accredited investor, or do these investors represent a *de minimis* segment of individual accredited investors?

A thorough examination of Rule 506 offerings would enable the Commission to determine whether significant issues exist with the participation by individual accredited investors, particularly those who are at the lowest spectrum of the income and net-worth financial standards.[335] If those risks are determined to be untenable, the Commission would have an opportunity to develop more meaningful

334. Ultimately, should the purchaser representative be required to have a specialist's designation, such as the Chartered Financial Analyst? For example, CFA may not engage in activities that would pose a conflict of interest with the client. Rather, the CFA must "[p]lace the integrity of the profession and the interests of clients above [his] own personal interests." *Code of Ethics & Standards of Professional Conduct*, CFA INST. (2010), https://www.cfainstitute.org/ethics/codes/ethics/Pages/index.aspx.

335. *See supra* Part II.C.

standards for isolating participation in Rule 506 offerings to those individual investors who actually are able to fend for themselves.

Finally, how might we address providing investment opportunities for the smaller affluent investor who is not yet an accredited investor? Perhaps it would be useful to develop a regulatory structure for capitalist incubators, which might enable this class of investors to gain the competency to participate in Rule 506 offerings.[336] There are innumerable opportunities for entrepreneurs to develop their business models and receive expert support in executing their business plans,[337] and the Commission's rules provide an exemption for raising seed capital.[338] Comparable structures orientated to the needs of the individual investor could help smaller investors develop the capability to pursue their ambition to become capitalists.[339]

Capitalist incubators would bring together angel investors, issuers, placement agents, and research analysts who specialize in industry segments of particular interest to program participants.[340] A key aspect of the capitalist incubator would be the opportunity for program participants to interact with other investors, entrepreneurs, and issuer representatives. Successful program participants could use their incubator experiences to substantiate their investment sophistication for purposes of future Rule 506 offerings.

A capitalist incubator could be sponsored by a university, business school, research center, or state or regional economic development center.[341] As we approach Regulation D's thirtieth anniversary, this may be an opportune time for the Commission to conduct a comprehensive study of the operation of Rule 506. The program would be developed to meet individual objectives. Investor participants would receive instruction and guidance on various concepts, including identifying and managing risks of their portfolios, conducting due diligence, selecting investment advisors and

---

336. *See* Duke K. Bristow et al., *Venture Capital Formation and Access: Lingering Impediments of the Investment Company Act of 1940*, 2004 COLUM. BUS. L. REV. 77, 116–17.

337. *Business Incubation FAQ*, NAT'L BUS. INCUBATION ASS'N, http://www.nbia.org/resource_library/faq/index.php#5 (last visited Jan. 6, 2011).

338. 17 C.F.R. § 230.504 (2010).

339. *Comments on Proposed Rule: Prohibition of Fraud by Advisors to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles*, *supra* note 330.

340. *See* Bristow et al., *supra* note 336, at 116–17.

341. These entities have experience sponsoring business incubators for early-stage companies. *Business Incubation FAQ*, *supra* note 337.

evaluating their performance, selecting accountants and legal counsel, and understanding the investors' personal investment decision-making biases. The investor would work on teams with experienced and other professionals to evaluate prospective private offerings. In addition to ethical formation (Foreign Corrupt Practices Act, insider trading, inculcating a culture of legal and regulatory compliance, etc.), the incubators would stress the investors' moral obligations underlying decisions to commit capital (i.e., accepting personal responsibility for one's investment decisions). The tools for managing risk and conducting diligence—on investments or financial or other professionals—could be developed as applications that can be run on smart phones, personal digital assistants, personal computers, or other social or electronic media.

VI. CONCLUSION

The systemic failure of numerous Madoff investors, who arguably are sophisticated investors, to conduct due diligence may not be an isolated event. It illustrates the general failure of sophisticated investors to conduct due diligence on privately offered securities transactions—a problem that is not restricted to offerings of financial instruments or pooled investment vehicles, such as hedge funds, but can also exist with investments in "operating" companies.[342]

It is important to acknowledge that the private offering exemption continues to provide important benefits for the U.S. economy and poses insignificant risks when the class of investors is restricted to sophisticated investors.[343] It is not apparent that the accredited investor standard is a proper substitute for that special relationship or special knowledge of the issuer that marks the sophisticated investor.[344] As we approach Regulation D's thirtieth anniversary, this may be an opportune time for the Commission to conduct a comprehensive study of the operation of Rule 506. Conducting a study of the Rule would enable the Commission to determine what aspects of the Rule work well and what aspects may require refinement, particularly as to participation in private offerings by individual accredited investors. Ultimately, for us to realize the benefits of robust capital markets for our economy, we must enable all investors—including the affluent individual investor—to

342. Susan Carey, *Roots of $3 Billion Fraud Case Lie in DVD Players, Not CDOs*, WALL ST. J., Apr. 22, 2009, at A1 (reporting that unlike Madoff, Tom Petters allegedly "gulled his victims with nonexistent DVD players and flat-screen TVs").

343. *See supra* notes 322–25 and accompanying text.

344. *Supra* Part III.E.

participate in capital markets according to the particular investor's choice and tolerance for risk. The capitalist incubators could help develop skilled individual investors who may use the experience to qualify as accredited investors.[345]

We will not prevent investors from making improvident investment decisions because of their inordinate desire "not to miss out" on a hot investment or their greed. Thus, the focus of legislative and regulatory initiatives should not be to raise the expectations of the investing public that new laws or regulations can eliminate all vestiges of fraud, thereby relieving investors of any responsibility for the manner in which they conduct their investment activities (including due diligence) in private offerings.

Rather, the focus should be on the following: (1) to militate against the potential devastation of the smaller investor—those capital market participants least able to fend for themselves or bear the risk of devastating financial loss, and (2) to shield taxpayers from effectively "underwriting" the risk of putative private investment activity.

345. *See supra* text accompanying notes 328–32.