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Time to Rethink the "Sophisticated Investor"

Peter Morris

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Time to Rethink the "Sophisticated Investor"

Peter Morris – Independent Researcher[1]

Abstract

Policymakers need to change the way they think about so-called "sophisticated investors." The way they think about these organizations now disenfranchises the millions of ordinary people these big investors represent and makes it literally impossible to hold such big investors to account. This creates a dangerous flaw at the heart of the way financial markets are organized. This is not just abstract musing: it is demonstrably leading to poor outcomes for the ordinary people who depend on big investors. The good news is that policymakers can make a difference by applying a simple principle to "sophisticated investors": accountability. It need not cost a lot or involve a lot of bureaucracy. They must demand that big investors, and the fund managers they hire, disclose more to the public. What they disclose must allow (truly) independent outsiders to analyze how well the big investors have performed, including how cost-effective they are. Anyone who believes in markets knows that harnessing people's self-interest helps to make markets work. If policymakers choose to enfranchise the rest of society, they will be doing just that. Vested interests – including much of the financial services sector, many big investors, and even some policymakers – will call this idea outlandish. Some will portray it as an attack on financial markets. Even observers with no vested interest may worry that it will damage markets or the economy or both. Nothing could be further from the truth. An 80-year-old parallel shows the way. This change in approach would help to ensure that financial markets serve society as a whole, rather than just the people who work in them.

1 The author worked as a credit analyst for twenty-five years, most recently at Goldman Sachs and Morgan Stanley. Since 2009 he has been a consultant working in various areas including social investment. His independent research on private equity has appeared in academic and other publications, as well as at www.ssrn.com. He can be contacted at morrisp1@aol.com.

THE OFFICIAL STORY

The consensus view of "sophisticated investors" goes like this.[2] Unlike retail investors, big institutions like banks, insurance companies, and pension funds can look after themselves.[3] For that reason, policymakers give these organizations a free hand when it comes to investing (subject to any other rules they have to follow).

These organizations control most of society's wealth. That means the rest of society needs them to make good investments. The reason policymakers give these organizations so much freedom is that they assume they will in fact make good investments. Over the last thirty years, "sophisticated investors" have put an increasing proportion of their portfolios into so-called "alternative investments": hedge funds, private equity, commodities, and the like.[4] According to the official story, that just shows by definition that these must be good investments; hence there is no need for policymakers (or anyone else) to check if that is true.

Suppose outsiders want to check if these really have been good investments. Policymakers make it hard for them to do so. That is because policymakers give "sophisticated investors" a second big break: they allow these organizations to operate in private. Some big investors disclose headline results to the public. But they do not have to supply data that would allow outsiders to review their performance in detail. This applies even to their own end-investors or beneficiaries. Take an individual member of a big pension fund, or a taxpayer who contributes to it, as an example.[5] They are unable to obtain data that would allow them, or an expert they employ, to assess how well either the pension fund's managers, or any firms they in turn hire, are performing on their behalf.[6]

"Sophisticated investors" themselves have generally been happy to go along with the official story that allows them so much freedom and privacy. They have argued that they know what they are doing, they are doing a good job for their stakeholders and that policymakers have no need to get involved.

The consensus view of "sophisticated investors" is reassuring. If it is accurate, then regulators are right to allow big investors so much freedom and privacy. But evidence of poor outcomes and excessive fees raises doubts about how accurate the story really is.

PROBLEMS WITH THE OFFICIAL STORY

The most dramatic proof that the "sophisticated investor" doctrine does not stack up is, of course, the banking sector. Banks are the archetype of the "sophisticated investor." Yet they made enough bad investments to bring down the global economy if taxpayers had not bailed them out.

But the story does not end there, and the high profile nature of the problem with banks must not be allowed to obscure a bigger issue. However unlikely this may sound, banks are only one symptom of a problem that extends much wider.

The rest of this article will look at a generic large defined benefit pension scheme, to which ordinary people, including pension scheme members and taxpayers, entrust their cash. The pension fund hires specialist third-party fund managers to invest some of its funds in "alternative investments." Many of the examples used will relate to private equity, but the underlying issues relate to all "alternative investments."

Even their proponents admit that on average, "alternative investments" make a lot of money for the fund managers who run them,

---

2 Despite being so widely used, the term "sophisticated investor" has no formal status. Rule 501 of Regulation D in the U.S. federal securities laws defines an "accredited investor." The U.K.'s Financial Services Authority maintains a "Qualified Investor register" and Chapter 3 of its Conduct of Business Sourcebook defines "professional investor" without ever using the word "sophisticated." However, both media and regulators regularly use this informal term – see for example Financial Services Authority (2006), 3.132: "As private equity investors are generally sophisticated…" This is misleading: using the word "sophisticated" implies, without any evidence, that qualified (or accredited) investors will by definition make good investments. This article uses quotation marks in order to indicate the term's informal status. Examples in this article are drawn from the U.S. and the U.K., but most developed economies' regulations make a similar broad distinction between classes of investor.

3 In more formal economic terms, policymakers assume that that these organizations do not suffer from information asymmetries, and that they act like principals rather than agents.

4 This article leaves the term "alternative investments" in quotation marks to signal that it lacks any clear or consistent definition. It uses the term "private equity" generally to refer to buyouts (formerly known as leveraged buyouts), not venture capital. The Universities Superannuation Scheme (USS), one of the U.K.'s largest pension funds, provides a typical example of the trend. At March 2001, the USS investment portfolio contained no "alternative investments." Fourteen years later at March 2015, about one-quarter of the portfolio (25.3%, or £12.5 billion) was invested in assets that appear to meet USS's definition of "alternative assets." See USS (2015).

5 The term "pension fund" in this article refers to a defined benefit plan.

6 The U.K.'s Occupational Pension Schemes (Disclosure of Information) Regulations 1996 make clear that individuals are only entitled to receive information about benefits. U.S. public pension funds each year file a Comprehensive Annual Financial Report (CAFR). The CAFR contains headline information about returns and some information about costs. As will be discussed later, however, the information does not enable a detailed judgment on how good a job either the pension fund or its chosen fund managers are doing. See Dang et al. (2015).

but rather less for the people who invest in them. A 2011 report by the World Economic Forum observed that "… the [private equity] industry has been organized so that most of the rents (profits) from these skills go to the fund managers themselves, rather than to the [investors]."[7] The situation is not so different for hedge funds. A comprehensive academic study in 2011 found that over time, investors in hedge funds receive on average net returns that are little better than the returns on cash [Dichev and Yu (2011); Aiken et al. (2013)].

Most are familiar with the fact that retail investors run the risk of paying too much for supposed fund management skills. In their case, the reason is easy to find: they know less than professional fund managers.[8] But the official story suggests that "sophisticated investors" are different. These organizations can afford to employ skilled professionals, hence it seems strange that they have received only mediocre net returns from "alternative investments."

One of the main reasons why big investors are earning poor net returns in "alternative investments" is that they are paying excessive fees to the fund managers they hire. Over the last couple of years, this subject has received some long overdue attention. In May 2014, a Securities and Exchange Commission (SEC) official gave a high-profile speech that cited a lack of transparency and high fees in private equity [Bowden (2014)]. Two weeks later, he told the New York Times that "In some instances, investors' pockets are being picked. These investors may be sophisticated and they may be capable of protecting themselves, but much of what we're uncovering is undetectable by even the most sophisticated investor" [Morgenson (2014)].

U.S. state pension funds are among the biggest investors in the world. The largest of them, CalPERS, controls investments of over U.S.$300 billion, of which it allocates about one-tenth to private equity. Their size would suggest that state pension funds should also be considered among the most "sophisticated investors." But in April 2015, a well-known pension fund consulting firm issued a report that stated "[l]ess than one-half of the very substantial [private equity] costs incurred by U.S. pension funds are currently being disclosed" [Dang et al. (2015)]. The rest of the year saw this topic receiving a good deal of media attention.

Why are these "sophisticated investors" under-reporting these expenses? The answer appears to be that they do not fully understand what expenses they are paying in the first place. In July 2015, senior financial officials from twelve large U.S. states and cities wrote a joint letter to the SEC, asking the regulator "to require [private equity fund managers] to make better disclosure of private equity expenses to [investors]" [SEC (2015)]. In October 2015, California's State Treasurer wrote to the investment committees of California's two largest pension funds, stating that: "Pension funds and other limited partners pay excessive fees to private equity firms and do not have sufficient visibility into the nature and amount of those fees (…) The current lack of transparency undermines our fiduciary duty to protect our members and the public at large. Without it, how can we ever hope to have a meaningful dialogue with private equity firms, regulators, and other investors about the appropriate level of fees that should be paid?" [Chiang (2015); FT (2015a, b, c); NYT (2015); WSJ (2015)].[9]

A picture has begun to emerge. "Sophisticated investors" earn mediocre returns (in aggregate) on "alternative investments." One key reason is that they pay excessive fees, which they themselves do not fully understand. It is hard to square this picture with the official story about "sophisticated investors."

The gap that is appearing between the official story and what actually happens in practice is quite wide. It would be easier to understand such differences if there were a plausible explanation for why things are not working the way they are supposed to.

Fortunately – or rather, unfortunately – there is a plausible explanation: incentives matter. The people who work for "sophisticated investors" may be acting perfectly sensibly. But if their incentives are wrong, the outcomes will be, too.

INCENTIVES MATTER: TOO BIG TO FAIL (TBTF) AND CONFLICTS OF INTEREST

Several factors may distort incentives for the people who manage large investments. As far as banks are concerned, the most obvious problem is moral hazard; the issue colloquially known as TBTF. A belief that an organization is TBTF can result in situations where skillful individuals end up making poor investment decisions.

Although moral hazard is usually associated with large banks, it also applies to some other "sophisticated investors" as well. Consider a U.S. state pension fund, which unlike a bank faces little, to no risk of failing overnight. Over a longer period, though, it may fall

7 World Economic Forum (2011), page 60. The report's academic research was supervised by Professor Josh Lerner of Harvard University, one of the world's leading experts on private equity.

8 In technical terms, there is asymmetry of information between the investor and the fund manager.

9 Also see coverage under "Private equity" at www.nakedcapitalism.com

short of its obligations. Such a "failure" would lead to difficult decisions about whether to reduce pension benefits or to increase contributions from taxpayers. In practice, as long as states remain unwilling to see pensioners starve on the streets, politicians will likely call on taxpayers to make up at least some of the shortfall. Public pension funds share with TBTF banks an implicit ability to call on taxpayers in an emergency. The moral hazard created is the same. In the case of a pension fund, its potential effects will simply unfold more slowly.[10]

A second distortion of incentives can arise from what economists call "agency problems" – in plainer English, conflicts of interest [Jensen and Meckling (1976)]. The staff who work for a "sophisticated investor" do not have the same interests as the people whose money it is looking after. After all, it is not their money.

Just like the directors of quoted companies, pension fund trustees are there to look after the interests of a large number of widely-dispersed stakeholders: that is, other people's money. Everyone, including policymakers, understands that looking after other people's money creates a potential conflict of interest for the directors of quoted companies. It should be easy to see that the same applies to pension fund trustees. They, too, are looking after other people's money. Aligning different people's interests is always hard, irrespective of the circumstances. There is no reason why big investors, such as pension funds, should be uniquely immune to this issue.

WHY HAVE PROBLEMS NOT BEEN ADDRESSED?

The principles of both moral hazard (TBTF) and agency problems (other people's money) are generally well understood. In some areas, policymakers recognize these problems and take active steps to address them. Think, for example, of all the effort that policymakers have put into trying to solve TBTF problems within the banking system since the recent crisis. It is hard to discern just how successful they have been in this regard, though the nature of the problem leaves policymakers no choice but to maintain in public that they have been successful.

As far as agency problems are concerned, policymakers have been trying for years to address the conflicts of interest that exist with publicly quoted companies. The U.K. alone has seen a string of reports, the Cadbury Report (1992) and Greenbury Report (1995), among others.

Where big investors are concerned, though, policymakers seem to overlook the agency problems that are inherent within public companies. They studiously ignore the idea that these same problems apply to big investors as well, leading them to make poor investments. This is either naive or disingenuous. Why have so many people placed such excessive faith in the "sophisticated investor"?

One possible answer would involve the notion of "fiduciary duty." Supporters of the status quo might point out that pension fund trustees have a fiduciary duty to look after the interests of their members. They might suggest that this is sufficient by itself to ensure that trustees will be effective in looking after their members' interests. But it is not.

The easiest way to see why it is not sufficient is to compare the position of a pension fund trustee with that of the chief executive of a quoted company. Both the trustee and the CEO are looking after other people's money. Both have a fiduciary duty to widely-dispersed stakeholders.[11] No one, however, would suggest that fiduciary duty is enough to ensure that a CEO will always act in the best interests of the company's shareholders. If fiduciary duty was sufficient, there would be no need to require companies to provide so much public disclosure. Nor would policymakers have put so much time and energy over the years into studies such as the Cadbury Code, the Greenbury Code, and so on.

Quoted companies have to disclose information that will allow stakeholders to assess the performance of fiduciaries, such as the CEO. Meanwhile, the fiduciaries who run pension funds are exempt from such requirements. This begs an obvious question: why does the consensus treat one set of fiduciaries (CEOs) so differently from another (pension fund trustees)?

The conventional answer might be that, unlike CEOs, pension fund trustees do not have the opportunity to enrich themselves at the expense of the stakeholders, whose interests they represent. Serving as a pension fund trustee is generally seen more as a public service than as an opportunity to make money. While CEOs can become rich if they perform well, pension fund trustees are paid more modestly and on a more or less fixed basis. Perhaps this explains why the consensus assumes that for trustees, as opposed to CEOs, fiduciary duty will be enough.

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10 The moral hazard present within large public pension funds puts them in a different position from some other "sophisticated investors," such as private university endowments. The trustees of a college endowment know that if they make poor investment decisions, their organization will have no claim on the public purse.

11 In the case of CEOs, this is a simplification. Strictly speaking, CEOs' fiduciary duty is to their employers (the company) rather than to the company's shareholders.

If so, the consensus is missing a crucial point: there is more than one way for interests to be poorly aligned. Pension fund trustees may not be able get rich at the expense of stakeholders, but that does not mean their interests are well aligned. Trustees' incentives are not skewed to the upside, like CEOs'. They are, however, skewed to the downside. Pension fund trustees face at least two forms of downside risk. Breaking legal obligations carries a cost for trustees. Less tangible, but arguably more significant, is reputation risk. Trustees whose funds underperform their peers will face criticism.

Being exposed only to downside risk is a recipe for risk-averse behavior. Unlike CEOs, pension fund trustees have no incentive to do anything different from their peers. Rather, they have every incentive to follow the herd. That is the best way for them to minimize the risk of underperforming their peers. Being too conservative can do just as much damage as taking too much risk.[12]

One way to think about fiduciary duty is as a legal device for trying to make agents (such as CEOs and pension fund trustees) act like principals (that is, as though they were looking after their own cash). Fiduciary duty gives pension fund trustees one incentive, but it is not the only one they face. The consensus is wrong to assume that because pension fund trustees cannot get rich, fiduciary duty alone will ensure they make optimal decisions on behalf the people they represent.

It may seem strange that the consensus has failed to think clearly about how agency problems affect big investors. Incentives may be at work once again, however, because most of those who support the "sophisticated investor" story have a vested interest in it. The people who work for big investors are bound to like the label "sophisticated" thanks to the freedom and lack of scrutiny that comes with it. They will earn more for looking after a complex "alternative investment" than for supervising simpler (and cheaper) investments.

A second group has an even bigger financial incentive to support the status quo: intermediaries such as banks, asset managers, consultants and lawyers. All of them do well if big investors use more complexity. For example, big investors pay consultants to advise them how and where to invest. It should come as no surprise to find that consultants have mostly supported the steady growth in complex (and expensive) "alternative investments."

A third and last group has (one hopes) influenced policymakers more than either of the first two. Its vested interest is also of a different kind. Conventional economic theory makes it an article of faith that big investors will (on average, if unconstrained) make good investments. Conventional theory chooses to ignore the moral hazard and agency problems discussed above. This means that mainstream economics has an intellectual vested interest in the "sophisticated investor" story. It has an incentive to turn a blind eye to what could be wrong with the official story.

PROPOSAL: MANDATORY DISCLOSURE

The flaws in the "sophisticated investor" story are easy to see. A simplistic view of fiduciary duty, combined with vested interests, may explain why these flaws have received less attention than they deserve until now. Finding neat and tidy solutions is hard.

But the people who depend on big investors cannot afford to wait for the perfect answer. This is not an abstract issue. If "sophisticated investors" do a poor job, ordinary people suffer. When ordinary people's own cash is involved, the impact is direct. The SEC's Andrew Bowden noted in 2014 that what happens in private equity "affects the retirement savings of teachers, firemen, police officers, and other workers across the U.S." [Bowden (2014)].[13] Even if their own money is not involved, ordinary people are vulnerable to indirect effects. At best, too much capital flowing into "alternative investments" reduces economic growth for the whole of society. At worst, taxpayers may find themselves bailing out banks in the short term and pension funds in the long term.

Both ends of the ideological spectrum will offer simplistic solutions. One end will suggest a raft of new regulations that prescribes in detail who can do what. For example, someone might suggest that big investors have to "prove" to regulators that they are good investors before being allowed to take on "alternative investments." The bureaucracy involved would be expensive and would not work.[14]

12 Readers familiar with financial options may find the following analogy useful in explaining how different the incentives are for CEOs and pension fund trustees despite the fact that they are both fiduciaries. A CEO's incentive structure can be compared to a long call option, which gives them an incentive to take risks. A pension fund trustee's incentive structure is the reverse: a short put option. An investor who is short a put option will try to minimize risk. (Thanks for this analogy are due to Jack Edmondson.)

13 In 2007, private equity firm Permira told a U.K. parliamentary committee "We have 30 million pensioners in our pension funds [sic] and millions of them are in the U.K. For instance, we have at least one million local government employees, past and present, who invest in our funds…" (House of Commons 2007, Ev 34.)

14 A variant on this could see "sophisticated investors" split into groups depending on their level of sophistication – see, for example, Tett (2010). It does seem strange, and perhaps dangerous, that the current rules make little distinction between (say) Goldman Sachs and a small local council. But this approach would also involve costly and tricky bureaucracy.

The other end of the spectrum will feature siren voices of the kind that have dominated finance over the last two generations. These will proclaim that the answer is simple: just get rid of agency costs by "aligning the interests" of principals and agents, and the problem will magically disappear.

"Alignment of interests" has acquired totemic status in the world of "alternative investments."[15] But that is a sign of how superficial the thinking behind it is. In reality, "alignment of interests" is a mirage. There is only one way to truly align the interests of a principal and an agent: that is literally to merge them. Anything less can only produce an imperfect alignment of interests. The alignment may be more or less imperfect, but that is all. And, paradoxically, imperfect alignment of interests is more dangerous than none at all. That is because it gives a principal false confidence that they can afford to stop worrying about their agent's conflict.

The agency problems that affect big investors are here to stay. They cannot be either avoided or eliminated. The most we can hope to do is to mitigate them. Anyone who believes in markets will accept that the most effective way to do this is to harness the self-interest of the people that big investors' money actually belongs to. This is where policymakers have a vital role to play.

Policymakers have to make it possible for ordinary people to hold accountable the agents, such as pension funds, to which they have entrusted their cash. This includes millions of pension scheme members and taxpayers. To hold someone accountable, you need to be able to assess their performance. But "sophisticated investors" are allowed to operate in private. That makes it impossible to see fully how they are doing.

Policymakers need to remove this exemption. They must make it mandatory for big investors, and the asset managers they hire, to release more information to the public.[16] The data disclosed must allow a detailed and truly independent analysis of how big investors have performed, including how much they have paid in expenses.[17]

The details of how to put this approach into practice lie beyond the scope of this article. Cracks have already started to appear in the historic consensus that big investors can look after themselves and should be left to operate in private. Events in the U.S. in 2014-15, discussed earlier, are one example. Something similar happened in the U.K. in 2014, though it received less publicity. The Chartered Institute of Public Finance & Accounting (CIPFA) is a body that oversees public sector accounting in the U.K. In June 2014 it issued a report that addressed the way local government pension schemes report the cost of investment management [CIPFA (2014)]. CIPFA essentially pointed out that pension schemes were under-reporting the costs for "alternative investments," in the same way that CEM Benchmarking's 2015 report did for private equity in the U.S.[18]

Assuming policymakers take on this challenge, they will have to be robust about what they do. Even when they have tried to make disclosure mandatory in the past, "sophisticated investors" and intermediaries have tried energetically to get around the rules.[19]

Some vested interests will go on resisting the idea that they should be more open. In November 2014 the Chief Executive of the U.S. private equity industry's lobby group wrote "The argument that [private equity] limited partnership agreements (LPAs) should be accessible to the public is akin to demanding that Coca-Cola publish its famous (and secret) soda recipe."[20] This is disingenuous. Morris and Phalippou (2012) show why this analogy does not apply to private equity. Information that is genuinely time-sensitive creates a real challenge. Zingales (2009) suggests an elegant solution: where appropriate, simply allow a time-delay on its disclosure.

Vested interests may also suggest that it is pointless to release more information because the average person would not be able to interpret it. Once again this is disingenuous. The fact that individuals cannot interpret such information is irrelevant. If the data were publicly available, independent experts without a vested interest (e.g., academics) would analyze them for free. This would

15 Blackstone, a major "alternative investment" manager, writes that "We strive to maintain a work environment that reinforces our culture of collaboration, motivation and **alignment of interests** with investors [emphasis added]" [Blackstone (2010)]. A randomly chosen "sophisticated investor" writes: "One of the greatest strengths of the hedge fund industry is the **alignment of interest** that is created with 'pay for performance' carry fee structure [emphasis added]" [Utah (2009)]. In 2007, private equity manager Permira told a U.K. parliamentary committee that "Our pension fund investors are some of the largest and most sophisticated in the world. They spend a huge amount of time doing due diligence on our funds and an inordinate amount of time looking at the **alignment of interest** between us and them. [emphasis added]." [House of Commons (2007, Ev 50)]

16 Zingales (2009) and Morris and Phalippou (2012) present more detailed arguments for mandatory and standardised disclosure.

17 As discussed earlier, current reporting by U.S. public pension funds is inadequate for this purpose.

18 One pension scheme that adopted CIPFA's new measures showed an almost eight-fold increase in the "investment management expenses" it reported for 2014/15, from £10.7 million to £81.2 million [West Midlands (2015)]. The scheme observed that "this is a change in reporting only and does not represent an actual increase in costs…" But it shows how dramatic the under-reporting of costs for "alternative investments" has been until now. As the Treasurer of California wrote in October 2015, "Without [a clear view of costs], how can we ever hope to have a meaningful dialogue with private equity firms, regulators, and other investors about the appropriate level of fees that should be paid?"

19 Abrahamson et al. (2012) is an alarming cautionary tale about how "sophisticated investors" try to evade even mandatory disclosure rules.

20 Steve Judge, CEO, Private Equity Growth Capital Council, PEHub, 3 November 2014. Available at: https://www.pehub.com/2014/11/confidentiality-of-limited-partnership-agreements-is-paramount/

lead to a more informed debate about an issue that has serious public consequences. No one expects the average person to be able to interpret data about tests for breast cancer. But nor does anyone expect a small group of insiders with a vested interest to be allowed to keep those data private and use them to extract rent from the rest of society.[21]

None of the routine objections from vested interests stands up to scrutiny. But privacy has become deeply ingrained in the world of "sophisticated investors." They have even persuaded many neutral observers that privacy is essential. Some historical context will help show how wrong this is.

A historical perspective

In 1913, the American lawyer Louis Brandeis wrote a series of articles about the power of the U.S. finance sector. In one of them he coined the phrase "Sunlight is said to be the best of disinfectants…"[22] 20 years later, opacity was still the norm. Even the financial crash of 1929 and the onset of the Great Depression had brought little change. Quoted U.S. companies were still able to get away with disclosing poor quality information. The incoming President proposed creating a new agency to address this problem. It was called the Securities and Exchange Commission (SEC).[23]

U.S. financial and business interests lobbied against it fiercely. "There is no important economic aspect of the economic life of this country," intones the President of the New York Stock Exchange in a surviving February 1934 newsreel, "whether it be agriculture, industry, banking or commerce, which will not be adversely affected by this Bill. This Bill, if passed by Congress, will not only destroy our security markets, but will as a necessary consequence interrupt the flow of credit and capital into business."[24]

80 years later, no one would suggest that the SEC is perfect – indeed, it receives criticism from both ends of the ideological spectrum.[25] But both academic and anecdotal evidence confirms that its disclosure rules have made U.S. capital markets work better than they would have done otherwise [Fox et al. (2003)].

In effect, the SEC shone the "sunlight" that Brandeis wrote about in 1913. Quoted firms now have to file standard financial reports. These must be timely, relevant and easy to obtain and compare. Doing so has not seriously damaged American firms' ability to compete. Disclosure clearly involves some cost. But any private cost is dwarfed by the public benefits that flow from creating deep and trusted markets.

80 years ago, finance sector lobbyists warned that improved disclosure by quoted companies would bring the U.S. economy down. It did not. Instead, it helped the market for quoted securities work better and regain public trust. Improved public scrutiny of "sophisticated investors" would have the same effect today.

Conclusion

Plenty of "sophisticated investors" make good investments. The vast majority of people who work for big investors are acting in good faith. Some "alternative investments" are good value for investors. None of these has anything to fear from improved disclosure. But policymakers have to think about aggregate outcomes: not the better performers, nor the inherited dogma, but overall reality. And outcomes appear to be sub-optimal. Where "alternative investments" are concerned, "sophisticated investors" in aggregate seem to be letting down the ordinary people who depend on them. One key reason is that big investors are over-paying the fund managers they hire.

Some people who believe in markets may find this idea hard to accept. In truth, they should be neither surprised nor downhearted. Agency problems (conflicts of interest) affect most other human institutions. It would be very strange if they did not also affect big investors. Agency problems are here to stay. They provide a very straightforward reason why big investors collectively do not do as good a job as the consensus view has simply assumed they do.

It is poor outcomes that make improved disclosure necessary. This is not a pointless, pro forma fishing expedition: it is the most market-friendly way to try and mitigate agency problems that are causing real harm. Anyone who believes in markets will understand that harnessing people's self-interest is a powerful tool. Policymakers can do that here by ending the monopoly big investors have historically had on key information. They must help outsiders (meaning, the rest of society) look after their own interests.

21 For evidence of finance sector rents, see Philippon and Reshef (2012).
22 Brandeis (1932). The title of Andrew Bowden's SEC speech in April 2014 was "Spreading sunshine in private equity."
23 Zingales (2009) draws a similar parallel with the creation of the SEC.
24 Available at http://www.sechistorical.org/museum/film-radio-television/. For the origins of the SEC, see McCraw (1984).
25 See http://www.reuters.com/article/2011/09/15/sec-schapiro-idUSS1E78D1QL20110915 and http://www.theatlantic.com/business/archive/2011/12/too-big-to-stop-why-big-banks-keep-getting-away-with-breaking-the-law/249952/

Better disclosure is not a panacea: it is necessary, but not sufficient. Nor must it be used as an excuse to dilute fiduciary protection for small investors or beneficiaries. Rather, it is a way to help make sure fiduciaries are doing their job well. Some finance sector insiders may lose out from better disclosure. But financial markets are supposed to serve the interests of society as a whole, not a small group of insiders. Regulators can and must help to make that happen by opening up "sophisticated investors" to proper scrutiny.

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