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A Modest Proposal:[1]

Let's End Conflicts of Interest in the Wealth Advisory Business

Mark Twain tells the story of the fly that attempted to settle on a tempting pot of hot milk. Only at the last instant did the fly realize just how sticky the surface of the milk was. He struggled mightily and, at the very last instant, tore himself loose. As he flew off the fly reflected on what an instructive experience he had just had, but that, on the whole, he would prefer not to do it again.

Twain's story pretty well summarizes investor reactions to the first three years of the 21st Century: damned instructive, but on the whole we'd prefer not to live through them again. The story also makes the important point that, even though we may understand an issue intellectually, sometimes we don't fully appreciate its implications until disaster stares us in the face.

The problem of financial conflicts of interest is a perfect example of our ability to understand a concept intellectually but fail to grasp its full significance. During the bubble markets of the late 1990s only the brain-dead could have failed to be aware of the many conflicts of interest that pervaded the financial world. And if we couldn't see them for ourselves, scolds like then SEC Chairman Arthur Levitt, then Vanguard Chairman John Bogle and many others were happy to point them out to us. The problem was that we didn't listen, and the reason we didn't listen was that no one told us (who knew?) just how much of our wealth was about to be destroyed as a result of these conflicts.

Let's look at some examples of conflicts of interest we knew existed, but the consequences of which were monstrously underestimated.

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[1] With a nod to the original "modest proposal," penned in 1729 by Jonathan Swift: *A Modest Proposal for Preventing the Children of Poor People In Ireland from Being a Burden to Their Parents or Country, and for Making Them Beneficial to the Public*. I won't go into detail about Swift's proposed solution, except to note that it is based on his trenchant observation that, "a young healthy child well nursed is at a year old a most delicious, nourishing, and wholesome food, whether stewed, roasted, baked, or boiled." Swift's culinary tastes may have been indelicate but he was an astute observer of financial markets. He coined the phrase "the madness of the crowd" and was the first to refer to an overheated market as a "bubble." Alluding to the notorious South Sea Company, Swift wrote, "The Nation will too late find/Computing all their cost and trouble/Directors' promises but wind,/South Sea at best a mighty bubble." (1721) Perhaps unsurprisingly for such a close student of the markets, Swift ultimately went mad.

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The Destruction of Wealth: 2000-2002

*"Analyzing what went wrong in the '90s,
we can identify two specific elements:
a decline in professional standards and
a dramatic rise in conflicts of interest."*
- George Soros[2]

The destruction of wealth by financial analysts. Throughout the 1990s the prima donnas of the investment world were the superstar financial analysts at global financial powerhouses. Analysts like Jack Grubman (Citigroup/Salomon Smith Barney), Henry Blodgett (Merrill Lynch), Mary Meeker (Morgan Stanley) and Frank Quattrone (Credit Suisse First Boston)[3] commanded enormous power and influence (to say nothing of compensation). We all knew, if we bothered to think about it, that most of these analysts were inherently compromised. They were attempting to serve both investors (who paid them nothing) and investment banking clients of their firms (who paid them millions). What we never quite internalized, until it was hammered home to us in the most brutal manner possible, was just how much investor wealth could be destroyed by relying on the recommendations of financial analysts who were *known* to be compromised. The losses on investments in dot.coms, telecoms and technology stocks are now measured in the trillions of dollars.

The destruction of wealth by accountants. Everyone knows that capital markets cannot operate unless investors have confidence in the financial numbers published by corporations. And we all knew, if we bothered to think about it, that the accounting firms that blessed these numbers were hopelessly compromised. These firms, or at least the big global accounting firms, made far more money selling consulting services to corporations than they did selling auditing services.[4] When the latter was endangered by the former, which was likely to prevail? What never quite penetrated, at least until Enron, Global Crossing, and so many others, was just how much investor wealth could be destroyed by relying on audits blessed by accountants who were *known* to be compromised. The answer, it turned out, was billions and billions of dollars.

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[2] *Busted: Why the Markets Can't Fix Themselves*, The New Republic (September 2, 2002), p. 19.

[3] Quattrone was not technically an analyst, but the head of CSFB's technology investment banking group, to whom all the tech and dot.com analysts reported. Many investigations of Quattrone's activities have been launched and he has been placed on administrative leave by CSFB.

[4] Even in 2000 and 2001, 72% of the fees corporations paid to accounting firms were for non-auditing consulting services, according to the Investor Responsibility Research Center. Cited in Gretchen Morgenson, *On Reform, It's Time to Walk the Walk*, Wall Street Journal (October 6, 2002), Section 3, p. 1.

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The destruction of wealth via executive stock options. During the 1990s corporations showered top executives with massive stock options packages, arguing that it was important to align executive interests with those of shareholders.[5] But we all knew, if we bothered to think about it, that stock options don't align executive and shareholder interests at all. For one thing, option holders have no downside exposure if stock prices fall, while investors, as we learned to our horror, decidedly do. For another, most executives must sell their stock once the options have been exercised in order to pay taxes, making them extremely short-term owners. Thinking this misalignment through, perhaps we ought to have been able to see that unscrupulous executives could game the system powerfully against us, boosting short-term financial results to prop up stock prices, then exercising their options and selling out before the inevitable price collapse. We were left holding the bag – instructive, all right, but not an experience we'd like to repeat.

We could go on and on analyzing conflicts of interest and the disastrous consequences for investor wealth: the practice of "spinning:" allocating hot, no-risk IPOs to powerful CEOs;[6] the collaboration between rogue corporations and banks that enabled the former to post hyped earnings through off-balance-sheet financing using special purpose entities while the latter kept quiet;[7] the use of armies of brokers to push technology and dot.com stocks into investor portfolios and to keep them there, even when the investors wanted to sell.[8] But the point is clear: investors chronically and dramatically underestimate the wealth-destroying consequences of relying on compromised advisors.

[5] These options packages also resulted in massive increases in CEO pay. According to William McDonough, President of the Federal Reserve Bank of New York, CEOs earned 42 times the pay of the average production worker twenty years ago, but earn 400 times that pay today. Greg Ip, *New York Fed President Chides CEOs on Hefty Compensation* (Wall Street Journal, September 12, 2002), p. A2.

[6] Charles Gasparino, *Salomon's Grubman Resigns; NASD Finds "Spinning" at Firm*, Wall Street Journal (August 16, 2002), p. 1. Wall Street's response to the outrage over spinning is to assert that every industry favors its best customers: allocating no-lose IPOs to CEOs of its best investment banking customers was nothing more than sound business practice. But this is disingenuous at best. The "customer" was the corporation, not the CEO. The huge investment banking fees came out of the shareholders' pockets and the hot IPO proceeds should have gone into the shareholders' pockets. Moreover, investment banks routinely underpriced IPOs in the late 1990s, transferring billions of dollars from investment banking clients and their shareholders to CEOs and the investment banks themselves. Sanford C. Bernstein & Co., for example, estimates that IPOs were underpriced, on average, by 30% in 1999. See Gretchen Morgenson, *Another Slap at Democracy on Wall Street*, New York Times (September 1, 2002), section 3, p. 1.

[7] Martin Mayer, *Banking's Future Lies in Its Past*, New York Times (August 25, 2002), section 4, p. 9; Julie Creswell, *Banks on the Hot Seat*, Fortune (September 2, 2002), p. 79.

[8] Bruce Kelly, *Merrill a "Boiler Room" during Tech Boom*, Investment News (August 19, 2002), p. 1.

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The Destruction of Wealth: 2003-200-?

"For an integrated investment bank like Goldman Sachs, conflict management is a core competence."
- Goldman CEO Henry Paulsen[9]

"A conflict of interest is a conflict of interest."
- New York Attorney General Eliot Spitzer[10]

It is too soon to know whether the conflicts of interest described above will be eliminated or at least dramatically reduced, but certainly important efforts are underway. Consider: the most conflicted of the superstar financial analysts have resigned in disgrace and face both civil and criminal sanctions; Arthur Andersen, once the most respected of the big accounting firms, is dead; billionaire CEOs are forced to endure "perp walks," arrested, handcuffed and paraded before the media; the pressure to expense stock options is intense, even in the technology industry; the practice of "spinning" is under intense scrutiny in the press, in Congress, and by the New York Attorney General; executives at major banks have been forced to appear before Congressional committees to defend their practice of making off-balance-sheet loans to the likes of Enron; the Sarbanes-Oxley Act is now the law of the land;[11] and tens of thousands of investor lawsuits and arbitrations have been filed against financial firms in an effort to hold them accountable for the wealth they destroyed through conflicts of interest.

ANOTHER CONFLICT: COMPROMISED WEALTH ADVISORY SERVICES

But, terrible as these conflicts were, there is another conflict of interest that has resulted in the destruction of far more wealth among affluent investors, but which has been largely underestimated by the investors that are victimized by it: namely, the conflicts of interest that infest the financial advisory business. As with the conflicts discussed above, it is not that investors are unaware of the conflicts. The real problem is that investors dramatically underestimate the wealth-destroying *consequences* of these conflicts.

Let's be clear about this issue: I am talking about financial firms that undertake to advise a wealthy client *generally*, not about firms whose relationship with a client is solely that of product vendor. We don't expect the Ford dealer to be objective about Chevrolet and we shouldn't expect Morgan Stanley's product sales team (i.e., the brokers) to be objective about Goldman's

[9] Mark Gimein, *The Enforcer*, Fortune (September 16, 2002), p. 84.
[10] Mark Gimein, *op.cit.*, note 9, p. 82.
[11] Among other things, the law establishes a new accounting oversight panel, the Public Company Accounting Oversight Board.

products. But when a firm is advising a family generally – so that the quality of its advice on strategies, products and services will profoundly affect the family's wealth and happiness – objectivity and very high professional standards are essential.

And yet, objectivity and high professional standards are perhaps the rarest of all qualities to be found among financial firms. Instead, what we almost universally encounter are hucksters for lousy products,[12] advisors with little experience advising wealthy families, limited product and service lines, aggressive sales tactics, and no concern whatever with the consequences of these conflicts on investor wealth.

Examples of wealth destruction on a grand scale resulting from conflicted advice are so common they go almost un-remarked-upon. I have now been advising wealthy families for almost three decades, long enough to watch substantial fortunes diminish into ordinariness through nothing more than a conflicted advisor's determination to keep family wealth in its own uncompetitive and over-priced investment products. "Shirtsleeves to shirtsleeves in three generations" occurs far more often as the result of poor financial advice than as the result of foolish behavior on the part of families. (Unless we count the use of conflicted advisors as foolish behavior, which it most certainly is.)

But the destruction of wealth can also occur in brief, spectacular fashion as the result of conflicts of interest. In late 2002, for example, two such cases were much in the news.[13] But we all know of many, many other examples over the years.

I have emphasized the fact that the conflicts of interest among financial analysts, accountants and CEOs were generally well-recognized by investors, and the same is true of conflicts in the wealth advisory business. Indeed, many financial professionals make no bones about them. The now-retired head of private banking for a major investment bank, when presented with the myriad conflicts of interest his firm brought to the process of advising wealthy clients, didn't waste his breath with denials. Instead, he had an effective rejoinder: "The people we are dealing with," he would say, "are consenting adults."

This may be as cynical a *caveat emptor* as an investor could wish to hear. We can re-phrase the banker's remark to say, "My job is to transfer wealth from your family to my firm. Your job is

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[12] "Almost everything Wall Street does is inefficient and benefits select insiders at the expense of regular investors. Many of its services aren't just useless, but damaging." Shawn Tully, *Is Wall Street Good for Anything?*, Fortune (September 16, 2002), p. 33.

[13] *Ex-Northpoint Exec Charges Goldman with Conflict of Interest*, Private Asset Management (August 19, 2002), p. 1; Susanne Craig, *Merrill Is Told to Pay Couple $7.7 Million Sum*, Wall Street Journal (August 28, 2002), p. C1.

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to look out for your own interests." But cynical or not, our tough-minded banker knew whereof he spoke. Wealthy investors are not the widows and orphans of the investment world, but substantial players with respect to whom sophistication is assumed,[14] whether it exists or not. When wealthy investors lose capital, no one outside the family mourns. And no one can be expected to come to the rescue.[15]

But, with rare exceptions, wealthy investors are no match for the top firms in the financial business. Few families made their capital in the financial industry, and hence they are Johnnie-Come-Latelies to the business. The best financial firms, by contrast, have been in the business for many decades – several centuries in a few cases. They employ smart, aggressive, well-trained, highly incentivized professionals who are relentless in their sales efforts. These firms deploy massive capital in an attempt to distribute their products as widely as possible. Families, by comparison, tend to be thinly-staffed and reactive, forlornly hoping that their advisor has their best interests in mind. As a result, in the competition between financial firms intent on selling inferior advice, products and services and families intent on preserving capital, families will always finish second.

Given the almost daily horror stories, why do families continue to rely on advice they know to be chock full of conflicts of interest? To help us gain a perspective on this puzzling phenomenon, let's take a very quick look at the history of independent advice in the financial services industry.

THE COMPLEAT[16] HISTORY OF OBJECTIVE ADVICE

Nearly thirty years ago – in 1974, to be exact – Congress passed the Employment Retirement Income Security Act, or ERISA. Among other things, ERISA applied the Prudent Investor Rule to pension plans and made it clear that plan trustees faced personal liability for violations of the Rule. Since few, if any, pension plan trustees knew anything about modern portfolio theory concepts of risk, return, diversification and so on, and since none wanted to risk incurring personal liability, a mad rush ensued to hire firms that did understand these concepts. Thus began the investment consulting business. Trustees of endowed institutions, who were also

[14] For example, the definition of an accredited investor is anyone with $5 million in investable assets. For some purposes, the threshold is as low as $1 million.
[15] The Securities and Exchange Commission, for example, does not consider investors with more than $5 million when it counts the "clients" of an investment advisory firm.
[16] Compleat, but not, of course, complete. Compare *The Compleat Angler*, by Izaak Walton; *The Compleat Cat*, by Cleveland Amory; and, best of all, *The Compleat Guide to Day Trading Stocks*, by Jacob Bernstein.

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fiduciaries, weren't slow to follow suit, and today it is difficult to find a sizeable pension plan or endowment fund that doesn't work with an independent, open architecture advisor.

Roughly ten years later, retail investors got into the act. In the mid-1980s, burned by churning of their accounts and propelled by a constant barrage of publicity in the mass media about the dangers of using commission-based advisors, retail investors began to move in overwhelming numbers to fee-only financial planners and discount brokerage firms. Firms like Charles Schwab & Co. rode this wave to great success – today more than half the assets at Schwab are accounted for by financial planners.

So where are the wealthy families? That leaves only one large group of investors still depending mainly on compromised advisors: wealthy families. In one sense, this phenomenon is easy to understand. Families often have legacy relationships with conflicted financial firms that are difficult to break, emotionally if not legally. In addition, at least until recently, wealthy families tended to be relatively isolated. The mass media had no interest in discussing issues of importance to only a few Americans (even though they controlled massive wealth), and privacy issues often prevented families from networking effectively.[17]

But in a more important sense the continued dependence on conflicted advisors is unfathomable given the critical importance of capital to wealthy families. Consider that if a pension plan loses capital due to conflicted advice or otherwise, the main consequence is that the plan sponsor (a corporation or public entity) simply has to increase its contribution level. If an endowed institution loses capital, the main consequence is that the fundraising staff has to redouble its efforts. Even for retail investors, private capital is typically far less important than earned income and retirement plans. But if a wealthy family loses its capital an irreplaceable loss has occurred that will affect the happiness of the family for generations to come. Family members responsible for the stewardship of family wealth – and, therefore, in some very large measure responsible for the future happiness of family members – would do well to consider the examples of pension plans, endowment funds and retail investors and to demand high quality, objective advice.

[17] The media continue to express little interest in the management of significant wealth, unless it involves a major investment disaster or family squabble. However, the relative isolation of wealthy families has been effectively shattered by the good work of intermediary groups such as the Family Office Exchange, the Institute for Private Investors, the CCC Alliance, and the many seminars and conferences for families sponsored by Lido, IIR and others.

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HOW COMPROMISED ADVICE HARMS WEALTHY INVESTORS

We all know intuitively that investment advice that is compromised is harmful, but how many of us have thought through exactly why this is the case and how the harm occurs? When we think about conflicts of interest, we typically focus on the problems that arise when an advisor is both attempting to give sound advice and also to sell an investment product (or, sometimes, a service). Because of the advisor's financial interest in making the sale, he or she is likely to over-estimate the value of the product and to underestimate the negative consequences for the investor's wealth of buying it, rather than buying a more competitive or appropriate product from another vendor – or simply doing nothing.

But this is only the tip of the conflict iceberg. I suggest that most of the wealth destruction caused to families by conflicts of interest arises out of the failure of the financial industry to acknowledge and respect the nature of families as clients, particularly the enormous *complexity* of families as investment entities. Consider that families: pay capital gains and ordinary income taxes at different rates; must separate long and short term gains for tax purposes; live with enormously complicated estate, trust and tax planning strategies resulting in entities with wildly differing tax treatments and investment planning considerations; often own complex operating businesses; sometimes hold their assets inside a C corporation which is classified as a personal holding company; sometimes hold their assets in an S corporation that was formerly a personal holding company; sometimes own very substantially appreciated (legacy) securities that are exposed to price declines that could devastate the family's wealth; employ investment decision-making strategies that are complicated and very different from those of institutional or retail investors; face intergenerational and other family-specific concerns that have deep emotional and psychological roots; are often focused as a family on matters other than wealth management (such as philanthropy). And this merely scratches the surface of family complexity.

Even the greenest broker cold-calling from his lonely cubicle is subject to the "know your customer" rule: generally speaking, he shouldn't be selling IPOs to elderly widows or fixed annuities to thirty-year-olds. Yet, when financial firms target affluent private clients – as virtually all financial firms do – they make little effort to know their customers. More typically, a firm goes after the private client business not by considering the needs of family investors but by focusing on distribution, asset gathering and cross-selling. The firm will organize a "wealth management group" consisting of a few retreads from the asset management division, some

under-employed investment bankers and a large helping of brokers. And voila! – they are in business.

Instead, financial firms who wish to advise private clients should be attempting to match their services to the complex needs of family investors. The first need that comes to mind is the one cited by George Soros in the quote that appears earlier: very high professional standards. Newly minted MBAs, brokers, reassigned professionals from investment banking and asset management groups, and similar personnel have little business advising family investors. It requires many years of experience to navigate the complex challenges presented by family investors, and therefore Rule #1 for financial firms wishing to build a private client business ought to be to recruit only the most senior professionals who have worked with complex, substantial families for many years. And Rule #1 for family investors ought to be to demand nothing less from their advisors.

As a result of the daunting complexity of family investors, the second need that comes to mind is the need for access to an enormously wide array of competitive products and services – *solutions*, really, for the many challenges family investors will face over time. Yet, no small or medium-sized firm can possibly have, in-house, all the products and services families are likely to need, and no large firm can possibly have *competitive* products across such a broad landscape. Hence, Rule #2 for financial firms wishing to advise large families ought to be that some form of an open architecture service platform should be made available to family clients. And Rule #2 for family investors ought to be to demand no less from their advisors.

Roughly 98% (my rough estimate) of the financial firms seeking to advise affluent family investors fail both of these tests – they don't employ professionals experienced in advising large families and they don't have access to a broad array of competitive products and services. These firms – smaller trust companies, regional banks, most asset management firms and investment banks – simply should not be in the wealth advisory business. Despite the apparent temptations of the business, their participation is likely to result in damage to their reputations, damage to the wealth of their clients, and potential legal liability.[18] Let's take a brief look at how the limitations of these firms damage investor wealth:

- The first step in the advisory process for most wealthy clients is making the crucial decision about how to deploy the family's capital. But a firm that fails Rule #1 will have little capacity to develop sound after-tax, after-fee, multi-investor, multi-period asset

[18] See Greycourt White Paper No. 26, *Is There a Duty to Give Objective Advice?* (forthcoming).

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allocation strategies, or even to understand the necessity for such a complex approach to asset allocation. If they take the trouble to purchase software that allows capital allocation decisions to be modeled on such a basis (an extraordinarily rare step for such a firm), their brokers will not understand how to use it or what its limitations may be. Moreover, because the firm violates Rule #2, it will have access to only a limited line of investment products. Hence, whatever asset allocation strategy is recommended will be based not on the family's needs but on what the firm happens to have handy.[19] The net result of violations of Rules #1 and #2 is that clients of these firms have their interests compromised from the very beginning of the advisory relationship. At the very least, they will end up with portfolios characterized by far too much embedded risk for the returns they can expect. At worst, the clients will experience dramatic and unnecessary destruction of their net wealth as the result of portfolios that are far too concentrated in too few asset classes and investment styles.[20]

→ Because Rule #2 has been violated, the investment products placed in the family's portfolio will be limited to those offered by that firm alone. Since no firm has a monopoly on quality, these products are likely to be largely non-competitive: over-priced, under-performing, possibly even inappropriate for the family's needs.[21] Compounding these disadvantages over time is one of the prime reasons for the decline of family wealth.

→ As the relationship continues, the complexity of the family's needs will continue to tax the financial firm's capabilities. Can the firm recommend cutting-edge estate planning strategies to the family? If not, the family's wealth may disappear in unnecessary taxes. Can the firm recommend appropriate strategies to hedge appreciated securities positions in the family's portfolio? If not, the family's wealth may be reduced unnecessarily. Can the firm tax-manage the family's portfolio? If not, the family will simply pay more taxes than necessary. Can the firm recommend possible solutions to a personal holding company problem? Can the firm help the family deal with

[19] Following are examples of investment products most smaller and mid-sized firms frequently don't have access to and which are therefore not included in portfolio design work done for their clients: different investment styles (growth, value, momentum, tech, top-down, bottom-up, etc.), US mid-cap stocks, US small cap stocks, international stocks, international small cap stocks, emerging markets stocks, international fixed income, high yield debt, directional hedge, absolute return-oriented hedge, venture capital, private equity, real estate, etc.

[20] A distressingly common example involves firms – including some large, global firms – that concentrate most of their clients' wealth in US large cap growth stocks. Net wealth declines in the 30% to 50% range have been suffered by many of the clients (or ex-clients) of such firms over the past few years.

[21] See the amusing article, *Can't Anyone Here Play This Game?*, by Tom Lauricella, Wall Street Journal (July 8, 2002), p. R1.

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intergenerational tensions? Can the firm offer solutions designed to improve the family's satisfaction with its philanthropic activities? Such questions become more and more embarrassing for firms that violate Rules #1 and #2.[22]

Since violations of Rules #1 and #2 cause such harm to wealthy clients, why would financial firms persist in violating them? The answer is conflicts of interest. Most firms don't employ investment professionals experienced in advising wealthy families (Rule #1) because such people are expensive, independent-minded, reluctant to sell uncompetitive products and generally difficult to manage. The fact that these are precisely the kinds of advisors wealthy clients need is a fact that is quickly lost in the firms' focus on their own short-term bottom line.[23] Most firms don't offer their clients access to a broad array of products, services and strategies (Rule #2) because they lack the expertise or capital required to do so and because they can't get paid to offer such advice. The fact that families need these products, services and strategies to avoid destruction of their wealth appears to be a matter of little concern to the industry.

CONFLICTS PRESENTED BY EVEN THE BEST FINANCIAL ADVISORY FIRMS

Let's assume either that the firms discussed above leave the wealth advisory business or that most families have the good sense to avoid them. Unfortunately, families aren't home free just yet. Of the (roughly) 2% of financial firms that don't violate both of our rules for advising wealthy families, half violate one of the rules and the other half violate the other. Let's examine how this works out in practice by considering a very common situation. We'll imagine a wealthy family headed by one N. Nelly. As a result of the capital markets environment we have all experienced over the past decade – a bull market followed by a bubble market followed by a bear market – Ms. Nelly, like many investors, holds a portfolio of substantially appreciated securities that are exposed to possible declines in value. Not being a sophisticated investor herself, Ms. Nelly conducts a search for a competent financial advisor. She is astute enough to avoid the

[22] It is true, of course, that it will be a rare family that will need all of these services. But the point is that virtually every family will need some of them as the years go by, and the failure to offer them in a competitive manner will have dramatically negative consequences for the family's wealth.

[23] Remarkable as it may seem, one occasionally encounters exceptional individuals working inside "closed architecture" firms who, somehow, find ways to insulate their personal clients from their own firms' conflicts of interest. These professionals manage to deliver largely objective and helpful advice, but unfortunately they are working very much at cross-purposes with their own employers. Many pay a price for focusing on clients rather than products. Faced these days with constant publicity about their firms' investor-unfriendly behavior, many of these individuals are bailing out – setting up their own shops, joining open architecture firms, or, unfortunately, leaving the industry altogether.

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98% of firms that violate both our rules, so let's see what is likely to happen to her in the hands of the remaining 2%.

The smaller firm problem. Ms. Nelly has been recommended to Patina Trust Company, a posh[24] mid-sized firm in New York that has been advising wealthy clients for many years. She visits the firm's offices and is immediately impressed by the marble entry, the wood-paneled lobby, the thick carpets, the old prints, the fine china in the private dining room. Everything about the place speaks of Old Money Well Managed. Over lunch she meets her relationship manager, a cultured gentleman who has obviously been advising affluent families for decades. The president of the company stops by to say hello. She is assured that the firm has seen every issue a family could possibly face and that her wealth will be in good hands. Deeply impressed, Ms. Nelly engages Patina as her general financial advisor. Over the next year or so her relationship manager is attentive, promptly returning phone calls and getting her monthly account reports out on time (usually). He is a charming lunch companion when she is in New York. He understands the benefits of diversification and attempts to educate Ms. Nelly about the importance of a sound asset allocation strategy.

Unfortunately, however, what Ms. Nelly most feared has begun to happen – her very large, concentrated securities positions begin an implacable decline. She is reluctant to sell her stock and incur large capital gains taxes, and her relationship manager, charming as he is, has no further suggestions. But Ms. Nelly is nothing if not persistent. She checks with several other financial firms and learns that complex hedging strategies can be employed to protect her appreciated stock positions. She engages in such a transaction with another firm, but not before she has lost millions of dollars of value. She fires Patina and brings a legal action in an attempt to hold Patina responsible for her losses.

From the point of view of the trust company, the lawsuit is unfair in the extreme. Patina doesn't offer complex hedging strategies and hence can't make a profit on them. Because such strategies are not part of the firm's product line it has not, naturally enough, bothered to educate its relationship managers about them. There are, Patina points out, a great many investment products, services and strategies that it does not offer and hence cannot possibly be held accountable for. The lawsuit should be dismissed for failure to state a claim on which relief can be granted. The entire financial services industry would agree with Patina's position – would, indeed, consider it to be self-evident.

[24] Posh – or POSH – was originally the designation for the most desirable staterooms on transatlantic cruise ships embarking from Southampton: Port Out, Starboard Home.

But Ms. Nelly sees the matter rather differently. In her eyes Patina has engaged in a simple bait-and-switch tactic. When Patina was competing for her business, it regaled her with its vast experience and capabilities, and she relied on Patina's representations. It may be true that Patina never directly stated that they understood securities hedging strategies, but they certainly left the impression that there was little or nothing about managing wealth that they didn't understand. And, as we know, the need for hedging strategies is a very common need. But now that much of her wealth has disappeared, Patina has taken the position that it is merely a small firm with limited capabilities and that Ms. Nelly's expectations, if they were otherwise, were unreasonable.

Unfortunately for Patina, the judge is inclined to agree with Ms. Nelly. After all, no one told Patina that it had to go into the business of advising complex, affluent families. If it decided to enter that business but not to bother gaining access to advisory services wealthy families were likely to need, it did so at its peril. When Patina was competing for Ms. Nelly's business, did it misrepresent its capabilities? That is clearly a matter for the jury to decide. The court denies Patina's motion to dismiss the complaint and Patina quickly, and wisely, settles the case.[25]

The lesson of the Patina example is that smaller firms invariably violate Rule #2: they have limited product and service lines, and hence virtually every complex family that engages a smaller firm will, sooner or later, come face-to-face with a compelling need the firm can't meet. In many cases, the family won't even recognize that it has such a need until it is too late, since the advisory firm either won't recognize the problem itself or won't mention it to the client (since it can't profit from a resolution of the problem).

The larger firm problem. Let's rewind our advisory videotape and assume that, instead of focusing her advisor search on small, exclusive firms like Patina Trust Company, N. Nelly had instead focused her search on large, integrated, global financial powerhouses. Ms. Nelly contacts Global Integrated Powerhouse, Inc., a fully integrated financial services firm with capabilities in banking, asset management, trust services, custody, lending, insurance and investment banking, among others.[26] She is invited to visit the firm's New York headquarters, where she is introduced to Global's senior officers and spends many hours with the firm's private wealth management unit. The firm demonstrates beyond any doubt that it has products,

[25] The "facts" of the Patina case have been invented by me, of course. But see *Levy v. Bessemer Trust Company*, (SDNY, July 30, 1997), which involved a similar set of facts.
[26] Note that, from the financial industry's point of view, amassing such broad capabilities simply increases the opportunities for cross-selling. But from the client's point of view such broad capabilities merely multiply the conflicts of interest.

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services and strategies that can address every conceivable investment challenge a wealthy family might face. Deeply impressed, Ms. Nelly engages Global as her general advisor.

Global assigns Ms. Nelly's account to a broker who operates out of Global's local office in Ms. Nelly's home town. This broker has little experience advising complex families, but he is an excellent golfer and proceeds to develop a personal (albeit strictly business!) relationship with Ms. Nelly. Unfortunately, however, what Ms. Nelly most feared has begun to happen – her very large, concentrated securities positions begin an implacable decline. She is reluctant to sell her stock and incur large capital gains taxes, and her broker has no further suggestions. But the decline in her stock value accelerates, and Ms. Nelly ultimately suffers losses measured in the tens of millions of dollars. Ms. Nelly terminates her relationship with Global and initiates an arbitration action in an attempt to hold Global responsible for her losses.

From the point of view of Global, the lawsuit is "outrageous." Global insists that, "We met all our duties and obligations as a broker." But from Ms. Nelly's point of view, this merely begs the question: were Global's obligations those of a retail broker, or were they instead directly related to the vast capabilities the firm bragged about when it competed for Ms. Nelly's business?

Unfortunately for Global, the arbitration panel agrees with Ms. Nelly. After all, no one told Global that it had to go into the business of advising complex, affluent families. If it decided to enter that business but didn't bother to hire experienced advisors capable of handling the complicated affairs of the wealthy, it did so at its peril. Global failed the "know your customer" rule, and hence the arbitrators hand down a very large award for Ms. Nelly.[27]

The lesson of the Global example is that larger firms invariably violate Rule #1: they work hard to develop a broad line of advisory products and services, but then rely on their existing brokerage armies to advise wealthy families, as though the needs of those families were no greater than the needs of retail investors. These global, integrated financial firms are all about product distribution and cross-selling, not about the needs of complex family investors. The failure to employ professionals experienced in advising wealthy clients ensures that virtually every complex family a large firm will advise will, sooner or later, have a compelling need the firm's brokers can't meet – or even recognize.

[27] The "facts" of the Global case have also been invented by me. But see *Millar v. Merrill Lynch*, in which a San Francisco panel of arbitrators handed down what was reportedly the largest arbitration award ever rendered. The decision is reported by Suzanne Craig, *Merrill Is Told to Pay Couple $7.7 Million Sum*, Wall Street Journal (August 28, 2002), p. C1. The quotes from "Global" in the preceding paragraph are from Merrill.

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The best of all possible worlds? Let's suppose that Global Integrated Powerhouse and Patina Trust Company were to merge. Global Patina now appears to offer "the best of all possible worlds:"[28] a firm that employs Patina's experienced wealth advisors (Rule #1), who now have access to Global's vast product line (Rule #2). But this Panglossian world is less ideal than it appears. While it is possible for a small firm to focus on a few things and to do them quite well, a large firm that strives to do everything will invariably do them poorly. Hence, if the former Patina advisors are going to do a good job for their clients, they will have to recommend that the clients use products of firms other than Global Patina. In other words, even in the best circumstances imaginable, firms that wish to advise wealthy families will have to introduce some form of an open architecture service. And we may wish to keep in mind that these "best circumstances imaginable" are just that: imaginable, but not real.

Introducing Objectivity into the Advisory Process

Let's assume for the moment that it would be a good thing if conflicts of interest were eliminated in the wealth advisory business. In other words, in the future when financial firms undertake to advise a client generally, they will do so from a platform that is largely objective. How could we get from here to there?

WHAT THE FINANCIAL INDUSTRY CAN DO

Despite the increasing clamor for objective advice, the industry has approached the provision of open architecture services with all the enthusiasm of a condemned man approaching the gallows. But in a world in which financial firms are determined to sell inferior products and investors are determined to preserve their wealth, financial firms and investors are natural enemies. Worse, in this worst of all possible worlds, financial firms are predators and families are the prey. This vicious cycle needs to be broken, and – long term – it is as much in the interest of the financial services industry as it is in the interests of families.

[28] This immortally ironic phrase was uttered (again and again) by that eternal optimist, Dr. Pangloss, a character in Voltaire's comic masterpiece, *Candide*. Voltaire, incidentally, was one of the earliest and most powerful advocates of free market economic systems, even pre-dating his younger friend Adam Smith. Voltaire popularized two ideas that continue to be of importance to wealthy families: the political legitimacy of the pursuit of wealth through market activity, and the moral legitimacy of the consumption of wealth. See Jerry Z. Muller, *The Mind and the Market: Capitalism in Modern European Thought* (Alfred A. Knopf, 2002), p. 20 *et seq.*

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Why would a supposedly sophisticated industry be so tentative in responding to an obvious client demand from such an attractive[29] sector of the market? The reasons are complex, but they have mainly to do with three factors, none of which is incapable of being overcome: entrenched corporate cultures, an understandable-but-bogus fear of disintermediation, and a misunderstanding of the economics of the open architecture business. Let's examine each of these issues briefly.

Cultural issues. Since the development of the modern financial services industry early in the twentieth century, financial firms have evolved into aggressive, sales-oriented cultures. This was not an outcome that was engraved in stone, but one that was prompted by the fact that investors have historically been unskilled, passive consumers of investment products. That is to say that investors have not traditionally shopped proactively for investment products and services – they don't typically sit down and determine what products and services they need, then go out and search for the best vendors. Instead, investors sit back passively and allow themselves to be sold various products and services, ending up not with an ideal constellation of products for their needs, but instead with those products sold by the most persuasive salesmen. Clearly, investors have been complicit in their own demise.

Hence, virtually from the beginning of the industry, if a financial firm was going to survive it had to develop an effective sales culture. Asset gathering has been the name-of-the-game forever, and the financial professionals who are able to gather the most assets are the most prized employees. At the top of every financial firm are the most able salesmen,[30] not the employees who have given clients the best advice. (The latter long ago migrated away from the sell side of the business.)

Corporate cultures are notoriously difficult to change,[31] but if ever a time was auspicious for a change in the culture of financial institutions, that time is at hand. I described above the many conflicts of interest among financial firms that have led to Congressional, SEC and even criminal investigations. But what I haven't discussed is the almost universal outrage among

[29] Wealthy families represent by far the most attractive target market for the financial services industry today. Pension plans and endowed institutions long ago switched to independent advisors, and retail investors are in the process of abandoning the capital markets, perhaps for a generation. Affluent families, however, are hugely under-advised and represent an ever-increasing proportion of the world's wealth. This gives families enormous clout in the struggle to get objective advice.
[30] In fully integrated financial services firms, the top officers may also come from the banking, lending, or investment banking sides of the business, and hence are likely to know very little about the financial advisory business.
[31] In the financial world, only Charles Schwab has demonstrated the repeated ability to cannibalize its most profitable products in order to move to an even more profitable strategy. It is largely for this reason that Schwab is the most feared firm in the industry.

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investors.[32] This outrage has had tangible results, such as the pummeling of stocks of firms like Citigroup and JP Morgan Chase, despite financial results that have been positive, and tens of thousands of lawsuits and arbitrations. Less obvious consequences include private clients who are migrating to independent firms and the quiet but determined decisions of many of the best financial professionals to leave the compromised, sell-side firms because they have concluded that they cannot, in good conscience, advise their clients effectively from those platforms.

In the occasional instances where an integrated financial services firm has acquired or built an "open architecture" unit,[33] the exercise has been compromised from the beginning by a refusal to understand that the culture of the firm has got to change to accommodate an objective, client-centered advisory approach. If the open architecture unit is simply appended to the existing firm without changes in compensation programs and reporting lines and without committed support from senior management, as though it were no different from, for example, asset management, the experiment is doomed to failure. For one thing, the employees in the open architecture units and the sales units will view each other with unrestrained hostility.[34] Open architecture professionals tend to view brokers[35] as venal predators, all-too-willing to compromise their clients for the sake of their own bottom line. Brokers tend to view open architecture advisors as supercilious Milquetoasts wholly unsuited to the rough and tumble world of private client work. (Ok, I exaggerate for effect. These points of view are caricatures, but only just.)

The fear of disintermediation. It seems logical to suppose that if an open architecture alternative were made available to the clients of a financial firm, those clients would, in overwhelming numbers, demand that their portfolios be advised from that platform. This would result in thousands of clients dropping out of uncompetitive proprietary products and strategies and migrating to best-in-class products and strategies, with dramatically negative financial consequences for the firm. But in fact there is no evidence that this sort of

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[32] Several recent studies have documented the increasing restiveness of affluent investors who are advised by conflicted firms. See, for example, *Corporate Scandal and the Lack of Advisor Objectivity*, The Spectrum Group, Inc. (2002). The study is described in *Investors Prefer Brokers' Advice to be Free of Conflict*, Wall Street Journal (September 10, 2002), p. D2, and *HNW Investors More Leery of Investment Bank-Affiliated Advisors*, Private Asset Management (September 16, 2002), p. 1.

[33] I put the term "open architecture" in quotes because these units range from truly open to semi-open to semi-closed architecture platforms.

[34] The head of one open architecture unit appended to an integrated financial firm admitted that fewer than 5% of the brokers in the firm had ever – *ever* – referred a client to the open architecture unit. (Personal communication to the author.)

[35] When brokers are assigned to private client work they are almost never called "brokers," of course. But salespeople whose financial incentives encourage them to push product regardless of quality and client need are brokers, whatever the firm calls them. One happy result of a broad move to objective advisory platforms will be a reduction in the number of over-compensated, over-testosteroned high net worth brokers.

disintermediation represents a danger. Indeed, when financial firms have offered something resembling an open architecture option, disintermediation hasn't occurred at all, except in a positive way: clients who would have left the firm to seek an open architecture alternative in fact stay in-house but move to the open architecture platform.

This counterintuitive phenomenon occurs because, as noted above, investors are poor consumers of investment services. Although they may be invested in inferior proprietary products and may be receiving compromised advice, most private clients won't act until their investment results are truly horrific – in other words, until it is too late.[36] Unfortunate as this may be, it gives financial firms the luxury of offering open architecture alternatives without suffering what, in a more just world, would be a serious penalty.

The economics of open architecture. Finally, financial firms don't offer open architecture options because they fundamentally misapprehend the value of an open architecture unit. Open architecture fees are typically lower than asset management fees (*everything* is lower than asset management fees), and therefore if a financial firm simply assumes that open architecture clients will substitute for asset management clients, the firm would never offer open architecture services.

But there are many defects in this line of reasoning. The first is making a straight-line projection based on current revenue growth and profitability levels of asset management services. Asset management generally, and especially asset management as it is practiced by larger financial firms,[37] is rapidly becoming commoditized. Fees are being driven down and competitive standards are rising, resulting in a significant decline in both revenue and profitability of asset management services at large institutions. Therefore, if a financial firm compares the *future* value of asset management services against the *future* value of open architecture services, the latter will appear far more appealing.

[36] "Too late" because the mathematics of very negative investment results are lethal. A portfolio that is down 50% must appreciate 100% simply to get even – a highly unlikely proposition. Consider, in light of this fact, the fate of clients who owned tech and dot.com securities that declined in price by 90% or more. These investors would have to achieve appreciation of 1,000% *merely to get their capital back*. Such investors are, in other words, permanently impoverished. Losses on this order were common among investors working with compromised advisors, but such losses are virtually inconceivable for investors working in an open architecture environment.

[37] Large firms tend to be inhospitable environments for talented money managers. With rare exceptions, money management units at large institutions are simply pale, over-priced, lower-returning versions of the superior products offered by smaller, boutique money management firms. See *Can't Anyone Here Play This Game?*, *op. cit.*, note 19. Large institutions tend to be competitive in products that require large scale (such as index products) or where buying power can be especially important (as in cash and fixed income management, where the cost-to-potential-return ratio is daunting).

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But the value of open architecture services for an integrated financial firm doesn't stop there. Because the open architecture unit will be working with the world's largest and most demanding investors, that unit's professionals represent a kind of early warning radar for the kinds of strategies, products and services that investors will be demanding in the future. This will give the financial firm a large competitive advantage in the race to develop products for which there will be an assured market. Finally, because open architecture professionals are in the business of evaluating investment products, they possess the intellectual capital required to design and build best-in-class products across the capital markets. Large firms that have more competitive products and fewer uncompetitive products will prosper versus their more traditional competitors. In short, the first financial firms to offer truly open architecture services will quickly come to dominate the private client business.

Endnote: Why Should We Care about the Fate of Wealthy Family Investors?

"The most remarkable thing in the world
is compound interest."
- Albert Einstein

Memo to Dr. Einstein: Net of spending,
families compound faster than interest.

Many people, unfortunately including many financial professionals, would ask why we should care about the fate of wealthy family investors. After all, they are big enough to fend for themselves, and if they don't, what's the harm? It simply means that their children or grandchildren will have to go out and get jobs like everyone else.

But there is another way to look at wealthy families, namely, that their wealth, and the sound stewardship of it, is as important to all of us as it is to the families themselves. Every American family that is wealthy today got that way because some family member did something, either through incredibly hard work or extraordinary brilliance (or, more often, both), that was exceptionally valuable. So valuable that in a free market, where the prices of goods and services tend to be efficient, someone was willing to pay that family a very large sum of money for whatever it had produced.

But the value to American society of wealthy families isn't just measured in how much someone was willing to pay them for what they produced. America is only one of many free markets around the world, but it is by far the most productive and innovative, and the main reason it

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holds that distinction is that Americans know that if they work hard and make sacrifices they have a reasonable shot at becoming rich. This incentive to maximize individual initiative makes America a far more vibrant, rich and, yes, wealthy society than any other. It also makes us a magnet for talented and ambitious people everywhere

This wealth enriches American society in obvious ways, of course: in the payment of taxes (affluent Americans pay most of the income taxes Uncle Sam collects) and in the extraordinary generosity of wealthy American families, both individually and via the foundations they create and the institutions they endow. But the most important aspect of American family wealth is less obvious: as creative individuals produce better products and services and more efficient ways of doing things, everyone in the society is enriched, whether or not they themselves are working hard or producing anything of value. Even the poorest Americans live in a world that is richer, more interesting, and more full of opportunities than the poor in any society that has ever existed. Without the incentives to become wealthy that America provides, we could still operate a free market economy, but that economy would better resemble France or southern Italy, societies that are culturally hostile to individual initiative. In short, then, we should care about the fate of wealthy families because their capital is as precious to us as it is to them.

We will be happy to discuss this memo at your convenience.

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