1 CUSTOMER MANDATE

Serving Customers' Interest Faithfully

The Wells Fargo Case

In my research for this book, I spent many months trying to identify ethical role models in finance. One name that repeatedly came up in the context of the US banking industry was John Stumpf.

One of eleven children, he was raised on a dairy and poultry farm in Pierz, Minnesota. He first worked in a local bakery before enrolling in college and becoming a community banker. Industry analysts I interviewed in 2013–2014 were uniformly impressed by his civility and no-nonsense approach. Articles on Stumpf consistently highlighted his Mid-Western rural upbringing and values. In its 2013 Banker of the Year profile of Stumpf, industry publication *American Banker* noted the frugality of his office and the pervasive folksiness of his senior managers as the self-conscious marks of a values-based bank.[1]

After many years in senior management roles, Stumpf became CEO of Wells Fargo in 2007. Wells Fargo was a trusted, community-oriented bank, founded in 1852 in San Francisco as a bank and express delivery service. It had deftly navigated the real estate bubble of the 2000s, largely eschewing the sirens of subprime mortgages. Stumpf's steady leadership enabled Wells Fargo to emerge stronger from the financial crisis than most other large US commercial banks. He was widely praised for his ability to implement one of the largest bank mergers in history, integrating Charlotte-based Wachovia, the fourth largest bank in the United States, on the verge of collapse at the time of

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its acquisition. Under Stumpf's watch, Wells Fargo became the largest US bank by market capitalization and the largest bank employer in the country. By 2015, it reached number seven in *Barron's* "World's Most Respected Companies" list.[2] Stumpf could do no wrong. I was pleased to have found a titan of the banking industry to portray as an ethical role model.

And of course, a colossal scandal surfaced in September 2016. It emerged that 5,300 Wells Fargo brokers had created 2.1 million checking and credit card bank accounts – a number later re-appraised at 3.5 million, without the consent of their customers. An investigative report dating back to 2013 had already uncovered evidence of this fraud, but few would have anticipated its magnitude.[3] Besides, it didn't fit the prevailing narrative on Wells Fargo.

This scandal was all the more confounding because it came out of a commercial bank that was portraying itself as having deep roots in its communities – not from your typical aggressive New York- or London-based investment bank. And it wasn't a case of complex finance which required industry specialists to parse out whether a true breach of trust had taken place between finance professionals dealing in esoteric capital markets instruments. Employees had created fake accounts for their unsuspecting retail customers. For some of the duped customers, this represented no more than a nuisance. For others, the fraud had real implications. Unsolicited credit card accounts could negatively affect credit ratings or even place customers into collections when unauthorized fees went unpaid.[4]

While Stumpf initially tried to frame the breach of trust as the work of rogue employees, it quickly became apparent that it spawned from deep inside the company's culture. For years, intense pressure had been put on employees to sell as many products as possible to their existing clients. In Wells Fargo's 2015 annual report, Stumpf wrote that cross-selling enabled the bank to develop "deep and long-lasting relationships" with customers.[5] It is also more profitable to sell additional products to existing customers than to acquire new customers. The emphasis on cross-selling was initiated by Dick Kovacevich, Stumpf's widely admired predecessor. Kovacevich perceived financial products as being no different than consumer products, calling Wells Fargo branches "stores."

On the surface, Stumpf accepted responsibility for the scandal but effectively directed the blame toward low-level employees. He

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resigned in the face of overwhelming criticism in October 2016. Wells Fargo paid $185 million for the fraud to regulators, including the US Consumer Financial Protection Bureau (CFPB), and another $575 million in a settlement with attorney generals of all fifty US states. It also paid hundreds of millions of dollars in refunds, settlements, and legal fees related to the fraud (and a $ billion fine in late 2018 related to its auto and mortgage lending practices).[6] In an unprecedented move, Janet Yellen imposed an unusual penalty on Wells Fargo on her last working day as Fed Chairwoman, capping the bank's assets at their 2017 year-end level, until the bank shows sufficient improvement in its governance. The bank has struggled to regain its footing with retail customers as the scandal has eroded the perception of its value proposition, although its valuation is consistent with that of other large US banks as of early 2020, albeit no longer at a premium.[7]

How could such a cancer be allowed to spread within an organization that touts itself as a main-street bank dedicated to consumer and small businesses? The factors at play all reflect industry-wide challenges. The first is that over the last decades, the finance industry has increasingly become a minefield of conflicts of interest. The fact that most large banks such as Wells Fargo are publicly listed creates a tension. The relentless pressure to deliver short-term results to boost shareholder value can too easily divert management away from the patient, solicitous handling of customers that is necessary to foster long-term relationships. Maximizing shareholder value, the mantra of listed companies for the past few decades in the United States and many other advanced economies, conflicts with putting customers' interest first if shareholder value is constantly measured on a short-term basis. The internal goals at Wells Fargo had little to do with its customers' interests and everything to do with shareholder value. These goals were pursued via an unforgiving incentive system, or punishment system depending on how one looks at it, that fetishized target numbers, to the exclusion of other considerations.

In theory, the goal of selling multiple financial products to existing customers was not nefarious in and of itself. Underlying that goal is the desire to create deeper relationships and a more loyal, stickier customer base, which is encouraged to source most, if not all, of its financial products from one trusted bank. As Stumpf insisted, "there was no incentive to do bad things."[8] In fact, the disciplined use of targets has become standard across the finance industry. Since the

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1990s, management consulting firms have converted their clients to "value-based management." Accordingly, all resources should be channeled toward increasing the value of the firm and its share price. Discipline toward that overarching goal is imposed by tying incentives to departmental-level targets on metrics that management deems to have the greatest potential impact on the firm's value. Where Wells Fargo stood out was in its uniquely aggressive cross-selling targets, and the relentless pressure on low-level employees to achieve these often unrealistic, short-term goals, no matter how they got there. Prior to the scandal erupting, a petition signed by 5,000 employees had called on management to lower sales quotas, to no avail.[9]

As of 2013, employees were reportedly asked to sell at least four financial products to 80% of their customers, while the stretch goal was the "Gr-Eight," meaning eight financial products per retail banking household.[10] That practice had been carried over by Kovacevich from his days as CEO of Norwest Corporation, prior to its merger with Wells Fargo. The intensity of Wells Fargo's targets was an outlier in the industry. For instance, a former Chase employee reported that she was given daily sales goals at Wells Fargo versus monthly ones at Chase.[11] Wells Fargo managers met with employees several times a day to report on their progress.[12]

These unrealistic goals spurred a culture of permissiveness – results at all costs, that led to fraud. Former bankers reported being pressured by their managers to invoke spurious reasons to convince customers to open new accounts – for instance, stating that it was unsafe to travel without separate checking and debit cards – or opening and closing new accounts for customers by claiming there had been fraud in the existing account.[13] Managers encouraged employees to order credit cards for pre-approved customers without their knowledge, filling forms using their name and contact information, and at times moving money away from existing accounts. Specific directives to open unrequested accounts came from branch as well as district managers, the very people who would have been expected to exercise oversight over the integrity of customer interactions.[14] In a staggering display of cynicism, Wells Fargo fired employees who reported abuses via the bank's formal internal whistleblower channel.[15] When it fired employees prior to the scandal becoming public, Wells Fargo would not inform its customers of the fraud or refund fees that had been illegally extracted from them.[16]

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A culture of results at all costs – and results not being inherently defined in ways that are consistent with serving the customer's best interest – necessarily stems from the top of the organization. As Stumpf stated during congressional testimonies, "I care about outcomes, not process."[17]

The fraud could be interpreted as the unintended consequence of poorly designed incentives – unintended because these fake accounts created no tangible value to the bank. Wells Fargo extracted approximately $2 million in fees from 85,000 of the more than 1.5 million unauthorized deposit accounts opened, and a bit above $400,000 in fees from 14,000 credit card accounts of the more than 565,000 that may have been unauthorized – a pittance in the context of a bank that generated revenues of over $88 billion in 2016.[18] It is implausible to think that Stumpf would have wanted these results to occur.[19]

Narrowly defined reward systems can lead employees to lose sight of their broader purpose. A 1990 study showed that when students were asked to proofread a paragraph for a marketing brochure that had both grammatical and obvious content errors, they were more likely to highlight both content and grammatical errors when asked to "do your best" than when they were specifically asked to focus on one or the other.[20] Examples abound of well-intentioned but narrowly defined reward systems gone awry. In the early 1990s, Sears set a sales goal of $147 an hour for its auto mechanics. This led to widespread overcharging and delivery of unnecessary services.[21] When goals are too challenging, they induce employees to adopt riskier and, at times, unethical practices.[22] A better approach at Wells Fargo might have been either to widen the reward system to incorporate targets that were aligned with their customers' interests or to shift the financial resources used to incentivize employees toward improving their customer value proposition – for instance, by reducing prices or creating new customer incentives.

While poorly designed incentives can promote self-serving behavior at the expense of customers, the personal judgment of employees should act as a safeguard. However, cognitive biases often prevent the exercise of independent judgment. Blind spots lead people to make unethical decisions without being mindful of the lack of moral consideration in their decision-making. Traditional approaches to ethics assume that most people recognize an ethical dilemma when they encounter one. In practice, they often don't.[23] Environmental and situational factors hold great sway on decision-making. Certain aspects of the

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finance industry – its complexity and opacity, the prevalence of information asymmetry between service providers and customers, and the pervasiveness of conflicts of interest – make finance professionals particularly vulnerable to cognitive biases. They are so deeply enmeshed in a complex web of engrossing incentives and high pressure that they can easily succumb to bounded awareness, the tendency to artificially bound the information they take into account in making decisions, favoring their self-interest at the expense of others. As Cambridge ethicist John Hendry has argued, finance is experienced by practitioners as a sophisticated game whose own complex rules tend to make them oblivious to any other considerations.[24]

Another cognitive bias, motivated blindness, can help explain why Wells Fargo's senior management and board failed to exercise oversight. Motivated blindness refers to people's propensity to not recognize other people's unethical behavior when that behavior furthers their own interest.[25] That pattern is often ascribed to rating agencies that extended high credit ratings to firms right before they collapsed, and to auditing firms that vouched for the financial numbers of firms that turned out to be fraudulent. In both cases, the presence of a strong vested interest not to highlight information that would endanger their lucrative contracts can stem from a bias, at times unwitting, to make generous assumptions that known problems are immaterial or bounded and thus not worth investigating further, or to avoid digging too deep.

In the Wells Fargo scandal, Stumpf and his senior management were arguably most at fault for the informal culture they engendered across the organization. Informal culture often trumps an organization's publicly espoused values. The "true values" of an organization tend to be internally disseminated through the behavior of managers and colleagues, stories they emphasize, and behaviors that are rewarded.[26] In its literature, Wells Fargo touted its honesty, trust, and integrity and emphasized its focus on defining its customer relationships along the customer's own definition of "financial success."[27] By contrast, many employees were rewarded for pushing, and at times imposing, products onto their customers that often did not respond to their needs. The Wells Fargo scandal illustrates how an inordinate focus on narrow goals can overtake and define an organization's culture.

For lower-level employees, behavior likely didn't turn egregiously unethical in one swoop. Patterns of deep breaches of trust often start with small ethical compromises which escalate along a slippery

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slope. Marketing experts Andris Zoltners, P.K. Sinha, and Sally Lorimer posit that the first step might be minor – perhaps advising a customer to take on a product that's not in their interest as a way to relieve pressure from unrealistic goals.[28] With goals still unattained, additional steps might include asking friends and family members to open new accounts, another incremental step. At this point, an employee might justify to him or herself opening a new account without authorization as yet another small incremental compromise, perhaps making the assumption that the new product won't generate additional costs for the customer and could be closed soon thereafter.

There are likely thousands of other Wells Fargo employees who swayed their customers to open new accounts for products that may not have been in these customers' interest, without resorting to deception. These employees might have considered themselves good soldiers for having successfully cross-sold products, and would have been rewarded for it by management. It's plausible that these employees advised their customers to take on additional products without devoting much, if any, thought to whether these products would be helpful to their customers. In such cases, bounded awareness and other cognitive biases can go a long way in explaining why good people can end up unwittingly breaching the trust of customers.

Are the 5,300 Wells Fargo employees who opened fake accounts good people who unwittingly made bad decisions? That is probably taking the argument a step too far. They were pressured, and in many cases bullied, into a pattern of deception for fear of losing their job by a dogmatic management group. While cognitive biases could have facilitated a slippery slope toward an increasingly self-serving relationship with one's customers, it is hard to imagine an employee opening an account behind the customer's back, at times creating fake email addresses to complete the application without alerting the customer, and doing so without ever thinking that this could represent a breach of trust.

Individual character plays a role and, in some instances, did act as a safeguard against immoral behavior. In the Wells Fargo scandal, the whistleblowers stand out for having made that judgment call and intervened, at great risk to their careers (and often, as it turned out, at the cost of their job). Another commendable, albeit less conspicuous, group of employees would have left on their own, perhaps quietly, because they felt uncomfortable committing breaches of trust, or would

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have been fired because they were not seen as performing given their unwillingness to cut ethical corners, as others were.

An Unfulfilled Responsibility

On the heels of the Global Financial Crisis, numerous scandals have come to light, from Bernard Madoff's Ponzi scheme to the Wells Fargo scandal. The creation of fake accounts at Wells Fargo symbolizes how the industry has increasingly deviated away from prioritizing its customers' interests. It is no surprise that trust in the industry is collapsing. In early 2020, the Edelman Trust Barometer, an annual global survey, showed financial services to be once again the least trusted industry amongst fifteen major industries, a position it has comfortably held for years.[29] As of June 2018, a Gallup poll showed that only 30% of Americans had confidence in their banks (to be fair, a significant uptick from June 2016, and still ahead of US Congress).[30] Simply put, many people now assume that their financial service providers intend to fleece them when they can, rather than serve their best interest.

This context of repeated scandals and eroding trust raises the question: What is the industry's responsibility toward its customers? And what is the standard to which it should be held?

The industry's duties and obligations toward its customers can be murky, certainly from the point of view of customers, due to a combination of overlapping regulations, intentional obfuscation, and, at times, the inherent difficulty in defining the exact role a finance professional takes on in serving a customer. In the United States, finance professionals recommending investments are not systematically held to a fiduciary standard. In some situations, they can breach a customer's trust while adhering to the rules and regulations technically applicable to their function.

The definition of who should be held as a fiduciary has constantly evolved. The term fiduciary stems from the Latin word for trust. The concept of fiduciary duty can be traced back to the Code of Hammurabi in Babylon, circa 1790 BC.[31] It appears in one form or another in the Old and New Testaments, Chinese historical texts, and Roman law, which articulated under Cicero the relationship of trust between an agent and principal.[32]

The entry in *Black's Law Dictionary*, the standard American legal dictionary, acknowledges that "fiduciary is a vague term, and it

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has been pressed into service for a number of ends."[33] To complicate matters, the legal recognition of a fiduciary duty in the United States varies from state to state. Fiduciary principles typically apply to professionals that have some discretionary authority and whose customers show some degree of dependence on these professionals' advice. In some instances, the definition simply emphasizes a relationship of trust and confidence. As a result, there is not one set of clearly identified roles that are held to that standard but a spectrum of functions that call for varying levels of fiduciary care. For example, while most brokers are not legally held to a fiduciary standard, some brokers with discretion or effective control over a customer's investment account have been considered to be fiduciaries.

The evidence suggests that explicitly extending a fiduciary duty affects behavior – in a study of large financial service firms selling annuities, brokers operating in US states where broker-dealers have a fiduciary duty to clients tend to sell simpler, lower-cost products and fewer variable annuities (which are often seen as carrying high fees and generating low yields) compared to brokers from states that do not impose that duty.[34]

Over time, courts in the United States have applied a fiduciary standard to an increasing universe of relationships, including investment bankers and clients, priests and parishioners, and even teachers and students.[35] A similar pattern is observable across markets, raising the bar in the duty of care of financial professionals, and particularly investment professionals. In the United Kingdom, the Kay Review of 2012, an independent review commissioned by the UK government in the wake of the Global Financial Crisis, argued that restoring trust in equity markets requires applying fiduciary standards across the investment value chain, and that contractual terms should never override this duty of care.[36]

But progress toward applying higher standards of care is not linear. Some seemingly straightforward applications of a fiduciary standard of care have generated fierce industry pushback. Consider the US Department of Labor's proposed Fiduciary Rule, which was to deem all professionals making investment recommendations or solicitations on retirement assets to be fiduciaries, not just those who charge a fee for service. This would have required all advisors to act in the best interests of their clients and disclose conflicts of interest. Implementation that was initially planned for 2017 was scuttled, under a Trump

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administration loath to impose new regulations, leading to a diluted version.[37]

Going back to the example of a universal bank serving large numbers of retail customers, only a subset of Wells Fargo professionals is subject to a fiduciary duty in the traditional sense of the word. Wells Fargo's management and board of directors owe a fiduciary duty to shareholders. Some professionals in specific roles are also deemed to owe a fiduciary duty to their customers: for instance, investment advisors, trustees in wealth management, and investment bankers when they perform "fairness opinions" to provide an objective perspective on the valuation of a business. But brokers and the bulk of professionals interacting with customers on a daily basis at Wells Fargo branches are not technically held to a fiduciary standard of care.

Yet banks such as Wells Fargo clearly aspire to become trusted advisors across their client-facing functions and exert influence. John Stumpf wrote in his 2015 letter to shareholders: "our highest honor is the trust that customers place in us. And trust is best built through relationships," adding that "we put our customers first" and that "we are committed to our customers' satisfaction and financial success and to work in their best interest."[38] *The Vision and Values of Wells Fargo*, the closest Wells Fargo has to a constitutional document, states that "We want our customers to see us as a trusted financial advisor, for outstanding service and sound advice."[39] Even though Wells Fargo is not technically a fiduciary for its customers in most aspects of its business, it is positioned as one, at least in its marketing. Customer representatives and brokers strive to become trusted advisors, but since the rules treat them as mere salespeople, they are afforded discretion to recommend to their customers products that may be reasonable but not ideal and to encourage behavior that may not be in their customers' long-term interest.

The image of trusted advisor or trusted partner that finance professionals seek to convey often conflicts with the predatory, at times even extortionary, nature of some of the products sold to retail customers. Credit cards are a case in point. Credit cards offer a critical service by facilitating payments and providing to consumers readily available credit to purchase goods and services. The popularization of credit cards in the 1960s ushered in a new era in consumer finance. They remain ubiquitous, facilitating the lives of millions of consumers. Some 44% of US households have credit card debt and 33% of Americans

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who have ever had credit card debt report having run up credit card debt from paying for basic necessities like health care.[40] Absent credit cards, they would have to turn to less institutionalized forms of funding, with potentially higher costs. Yet, the ease of access to credit cards can be too much of a good thing for consumers with limited self-discipline. Two out of five Americans with credit card debt report having built up their debt balance from unnecessary purchases. By charging what are arguably usurious rates on credit – an average of 14.9% in 2017[41] at a time when short-term US interest rates were close to 0 – as well as exorbitant fees on overdrafts, card companies can benefit from customers behaving in ways that are counter to their own interests.

Already in the early days of credit cards, a pattern of abuse emerged. Credit cards were simply mass mailed to bank customers considered to have good credit risks, without their requesting one. Many of these cards found their way to customers that were prone to overusing them. During the Lyndon Johnson US administration, Special Assistant Betty Furness likened that process to "giving sugar to diabetics."[42] Today, credit card companies continue to systematically encourage profligate spending on credit – the kind of behavior that senior executives of these card companies would discourage their own children from adopting. For instance, credit card companies tend to emphasize payment options that postpone full payments by using credit and don't warn debit card holders when they are about to trigger an overdraft – all subtle cues toward the less responsible behavior.[43]

They also tend to obfuscate the costs associated with building up debt. The average credit card agreement has 4,900 words and requires an 11th grade reading level, despite the 2009 Credit Card Accountability, Responsibility, and Disclosure Act and the simplification guidelines recommended by the US CFPB in 2011.[44] While readability has improved in recent years, these agreements remain unreadable to a majority of Americans as most Americans read at a level two or three grades below the highest grade they completed.

In open competitive markets, we would expect competition to channel customers toward those financial service providers that offer the most attractive terms and services. After all, customers can shop around, read customer reports, and compare notes with friends. But financial institutions tend to be aligned in their service offerings and research points to the fact that these institutions are often able to

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obfuscate the value of their products through complexity. Since the Global Financial Crisis, much of the input into the theory of competition has moved away from the notion that the equilibrium point tends to lead toward a Pareto optimal outcome, where resource allocation is such that any change could not make any individual better off without making another one worse off. In particular, Robert Shiller and George Akerlof, two Nobel prize winners, have argued that the equilibrium tends to be swayed toward whatever opportunity there is to fleece or manipulate customers.[45]

Financial innovation offers insight into this dynamic. Some financial innovation clearly benefits customers. The most beneficial new products are often those that create greater transparency, simplify things, and lower costs – passive index funds, for example. Even well-intentioned innovation – meaning innovation primarily designed to benefit customers, can backfire. For instance, peer-to-peer loans, once lauded as a way to disintermediate banks and reach an under-served population, have developed the allure of predatory lending. Recent data points to increasing delinquencies, a downward trend in credit scores for borrowers, and use of these loans to increase overall debt levels rather than substitute for high-rate credit card debt.[46]

However, in recent decades, innovation appears to have often been designed to benefit financial institutions more than their customers. For instance, innovation has driven greater retail product complexity, yet research shows that the more complex the product, the greater the profit for financial institutions and the lower the performance for households.[47] In a landmark study of retail structured products offered in European countries, where these products are more lightly regulated than in the United States, Claire Celerier and Boris Vallee showed that the most complex retail products tend to be targeted at households that are least likely to understand them.[48] For instance, they found that savings banks, which largely service lower-income households, offer more complex products than commercial banks. To illustrate the finding, they highlight the following product marketed by Banque Postale in 2010:

> Vivango is a 6-year maturity product whose final payoff is linked to a basket of 18 shares (largest companies by market capitalization within the Eurostoxx 50). Every year, the average performance of the three best-performing shares in the basket, compared to their initial

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> levels is recorded. These three shares are then removed from the basket for subsequent calculations. At maturity, the product offers guaranteed capital of 100%, plus 70% of the average of these performances recorded annually throughout the investment period.[49]

With a product of that complexity, whose evaluation calls for the skill set of an investment professional steeped in exotic options, retail customers need to entirely rely on the advice of the financial professionals with whom they interact. Yet these professionals are comfortable recommending products that tend to benefit the provider more than the customer.

A Fiduciary-Like Universal Principle

At the core, finance professionals are in the business of serving customers. By debating the finer points of who is a fiduciary and who is an agent or intermediary, and what the minimum standard should be for counter-parties, we can lose sight of the underlying principle that should be applied to all finance activities, which is that all finance professionals should serve their customer's interests faithfully. Even finance professionals who have a more narrowly defined role than traditional fiduciaries, such as customer service representatives and branch managers, should be held to a fiduciary-like standard, i.e. a fiduciary standard in spirit if not legally, because they render a socially important service to customers, who are in turn highly dependent on their financial professionals for sound advice. Retail customers of banking, lending, and investment services are especially vulnerable to self-serving behavior by finance professionals because of the technicality of financial products, the high potential for information asymmetry between them and their finance service provider, and the significant potential consequences of misguided decisions. Used-car dealers also endeavor to be perceived as trusted advisors but the ramifications of overpaying for a car once every several years are more benign than biased influence over relatively frequent and consequential financial decisions.[50]

In some instances, the dilemma faced by Purdue Pharma in marketing OxyContin, a powerful painkiller that has been prone to abuse and dependency, is the better analogy.[51] When brokers aggressively marketed subprime mortgages in the run-up to the financial crisis,

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they responded to a customer need but masked or at least glossed over the risks involved, and at times irresponsibly extended mortgages such as the infamous NINJAs, which required no jobs and no assets. At issue is a lack of self-regulation in the marketing of these products to a group of customers particularly vulnerable to dependency – an unemployed couple that gets a NINJA mortgage to purchase a house is at high risk of needing more debt down the road to service their mortgage.

Of course, there are limits to the analogy. Users of OxyContin often desperately need medication to alleviate their pain in a way that low-income households do not desperately need to buy a house. And while the opioid crisis primarily affects opioid users (with some indirect effects on the rest of the population), the subprime crisis triggered a collapse in home prices across the country, massive job losses, and a global economic slowdown. Still, the manner in which abuse of the availability of subprime loans contributed to a nationwide crisis in the United States has parallels to how the over-prescription and abuse of OxyContin and other powerful painkillers have led to a national opioid crisis.

In a world of increasingly complex products and relationships, simple principles can offer useful guidance. Serving your customers' interests faithfully is a simple and versatile articulation of that spirit. It echoes one of the three daily questions of self-examination that is attributed to Confucius: "In acting on behalf of others, have I always been loyal to their interests?"[52]

Should this universal principle equally apply to serving sophisticated institutional customers? Are there circumstances when the *caveat emptor* concept, which entails that the buyer alone is responsible for checking the quality of the purchase, should hold sway? Absent a traditional fiduciary relationship in which an institutional customer has entrusted a financial firm to make decisions on its behalf, the degree to which a fiduciary-like standard of care should apply depends on the extent to which the financial service provider is positioned as a trusted advisor in the context of a significant information, and at times knowledge, asymmetry. A pure market intermediary, for instance a market-maker who matches offers to buy and sell specific securities, should be held to a lower standard of care since he or she is not positioned as a trusted advisor. He or she should have a duty to share buy and sell quotes and to provide best execution with competence, diligence, and care.[53]

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But many roles in capital markets call for a combination of execution and advice. One of the best-documented examples of conflicts of interest in serving sophisticated institutional customers relates to Abacus, a $2 billion synthetic collateralized debt obligation (CDO) Goldman Sachs helped structure and sold to customers in 2007. This complex security was created in response to the desire of John Paulson, who led a large hedge fund, to gain short exposure to the subprime mortgage sector in the United States, which he expected to collapse. The synthetic CDO referenced specific residential mortgage-backed securities, which John Paulson helped select based on his view that they were poised to perform poorly or fail.

Abacus was structured as a zero-sum instrument, which required customers on both sides of the trade: long (betting that the underlying mortgages would increase in value) and short (betting that they would decline). On the short side, Paulson & Co. bought a credit default swap (CDS), paying a premium to the CDS writers, who took the long side of the trade, in exchange for a payout from the CDS writers if a credit event occurred in the reference assets (in the event the underlying mortgages referenced by the CDS went unpaid). Although Goldman Sachs hired ACA Management as a third-party portfolio selection agent, forty-nine out of the ninety securities that ended up in the portfolio of reference were selected by John Paulson.[54] Having coordinated the structuring of the security to suit Paulson & Co.'s interest in shorting it, Goldman Sachs successfully marketed the long side of the Abacus securities to three customers, including German bank IKB and ACA, which claimed it did not realize that Paulson & Co. would take the short side of the trade. Signs of deterioration in the financial health of the underlying mortgages surfaced soon after the deal was completed. In a span of a few months, the three investors lost more than $1 billion, while Paulson & Co. generated a similar amount in profit.[55]

Of the several aspects of misconduct Goldman Sachs stood accused of, failure to disclose material information loomed largest. In marketing Abacus, it omitted to mention that its one customer on the short side of the trade had picked a majority of the referenced securities to maximize the probability that the portfolio would fail. Presenting ACA as a third party ostensibly responsible for the selection of these securities masked John Paulson's role in structuring a security that was customized to his interests. Goldman Sachs omitted to disclose to clients

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it was soliciting for Abacus that as a firm, Goldman Sachs was also significantly net short the subprime mortgage market, meaning that it would benefit from a fall in prices, with views aligned with those of Paulson & Co.

At first, Lloyd Blankfein, CEO of Goldman Sachs, argued that the firm was not significantly net short the subprime mortgage market and, furthermore, that it did not bet against its clients.[56] Fabrice Tourre, the Goldman Sachs salesperson identified in the SEC claim, made the point that his clients were highly sophisticated institutions, implying that they should be expected to develop their own views and not rely solely on Goldman Sachs' marketing pitch.[57] He also argued that Goldman Sachs had acted in this case as a market-maker, meaning a simple conduit bringing together buyers and sellers without soliciting them, rather than an underwriter, thereby lowering the firm's duty to share material information.

These claims were debunked by testimonies under oath and internal Goldman Sachs emails.[58] Goldman Sachs had acted as an underwriter since it had created Abacus. It later surfaced that the firm was substantially net short the subprime mortgage market (a credit to its investment savvy since so few firms were prescient enough to anticipate the imminent meltdown), while actively marketing several securities such as Abacus to get some of its customers to take the long side of those trades.[59] In three synthetic CDOs similar to Abacus, Goldman Sachs took a substantial portion of the short side of the trade, without telling its customers on the long side.[60] At best, Goldman Sachs misled its customers on the long side, whether intentionally or not. In its settlement with the Securities and Exchange Commission (SEC), Goldman Sachs eventually recognized that it had been a mistake to omit disclosing the role of Paulson & Co. in Abacus's portfolio selection process, agreeing to pay a record fine of $550 million.[61]

The debate over the distinction between being a market-maker and an underwriter obfuscates the fundamental necessity to serve customers faithfully. In this case, it would not have necessarily entailed that Goldman Sachs disclose its own proprietary analysis supporting the negative view on the sector, or endeavor to convince customers that they shouldn't take the long side of Abacus, and thereby ensure that the security would never be taken up. There were still customers at that point in time that were interested in getting long exposure to the subprime mortgage market. Serving customers faithfully would

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have entailed disclosing all material facts related to the transaction and conflicts of interest while still offering them the possibility, once they had all this knowledge, to take on the long side of the trade because these customers explicitly wanted to express a long view, even if they understood it was diametrically opposed to that of the de facto portfolio selection agent, John Paulson, and of the underwriter, Goldman Sachs.

Holding yourself to serving your customers' interests faithfully is a guiding principle that requires adaptation to specific roles in finance. For a customer service representative, whose main role is to facilitate retail customer transactions, market products and services, and provide guidance to customers, being faithful to a customer's interest doesn't mean advising them to find a better, cheaper product at a competing bank. It means channeling them toward the products and services that are best aligned with their profile and interest, being transparent with the trade-offs involved, and refraining from pushing hard other products and services that are not ideally suited. For a sell-side trader who executes trades on behalf of institutional investors, it entails, for instance, not using the information to benefit the broker or another of the broker's clients. Evidence abounds that this breach of trust occurs frequently – a study showed, for example, that in the United States, clients of a broker employed by an activist investor to execute its trades tend to buy the same stocks as the activist prior to the activist's filing of a 13D form, which is required when an investor accumulates more than 5% of a company's shares and at times spurs a positive share price reaction.[62] Other studies suggest that brokers tend to share with selected clients order-flow information when they are liquidating large portfolios, enabling them to benefit from the information.[63]

This type of universal duty of care applied to a broad range of finance professionals is in the spirit of the principles of fiduciary duty released in draft form by Japan's Financial Services Agency (FSA), in 2017.[64] The FSA articulated seven principles, including foremost the duty to pursue the best interest of the client. Neither a rule nor a law, the duty underpinning these principles is meant to be freely adopted by financial service firms.[65] However, if financial service firms operating in Japan do not comply with these principles, they are required to explain why they don't, potentially putting them at a competitive disadvantage to peers that are compliant by shedding some light on areas in which they may not be systematically acting in the best interest of their

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customers. By targeting all "Financial Business Operators" that engage in customer service, and intentionally keeping vague the definition of who should be held to that standard, they are promoting a universal duty of care to be adopted by all finance professionals, consistent with the principle of serving one's customers faithfully.

Serving Customers' Interests Faithfully: Models of Fiduciary Leadership

How can finance professionals become fiduciary champions? The asset management industry offers a useful case study. For years, the industry's focal point was the heroic fund manager, striving to beat the market year after year. However, fund managers that beat the market in any given year are unlikely to do so consistently. The attention devoted to short-term outperformance obscured for a long time a problematic data point: The vast majority of asset managers underperform the market. According to S&P Dow Jones, over a fifteen-year investment horizon, 90% of US large-cap managers underperformed their benchmark index.[66] Extolling the exploits of the few outperforming fund managers has tended to divert attention away from the fact that persistence in returns tends to be low across the industry. S&P Dow Jones found that of the US equity mutual funds that were in the top-performing 25% of their peer group in the five-year period to March 2012, only 22.4% performed in the top quartile in the following five-year period to March 2017. In fact, a greater proportion of that top-performing quartile of funds in the five years up to March 2012 ended up in the bottom quartile over the following five years.[67]

The steep increase in assets invested in markets, the proliferation of funds, the draw of talent, and the application of new technologies have made it increasingly difficult for fund managers to find inefficiencies and capture alpha – returns in excess of the systemic risk they take on. A more sustainable approach for asset managers to faithfully serve customers is to reduce the cost of their intermediation. Research on asset managers suggests that the level of management fees and operating expenses that are charged to clients are the best predictor of future fund performance.[68] Advertising, marketing, and distribution are examples of expenses that are funded by management fees, but not supporting activities that are helpful to existing clients. In the United

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States, no one has done more to reduce the industry's costs than John ("Jack") Bogle, the founder of low-cost mutual fund company Vanguard.

The Returns of a Lifetime: Jack Bogle's Moment

Right up until his death in early 2019 at age 89, Jack Bogle lost no opportunity to make his case.[69] Every time the Vanguard Group founder came to visit my first-year students at Princeton University, as he did for the last several years no matter what physical shape he was in, he was quick to blast the asset management industry. "Too much costs, not enough value" – his deep voice and high energy would startle the students. He bemoaned the eroding sense of professionalism – managing money had become a "business." He lamented the rise of "speculation" over "investment." He extolled the value of hard work.

Those tenets could form a roadmap to Bogle's career as one of the most important figures in American finance over the past century. He epitomizes how finance can be a force for good by genuinely focusing on the interest of customers rather than those of the intermediary.

When he came to meet with my students at Princeton, he would talk about how he had stumbled upon a *Fortune* article on the nascent mutual fund industry in the Firestone Library reading room, almost seventy years prior. Up to that point, he had struggled to find his footing academically. A scholarship student at Princeton, he worked long hours in between classes. The article triggered his interest. He wrote his senior thesis on the ethical shortcomings of the mutual fund industry. His central argument: "Mutual funds can make no claim to superiority over the market averages." Decades later, his ideas around indexing finally caught fire. Vanguard, the asset management firm he founded in 1975 to address the very issues he had highlighted in his undergraduate thesis, is draining assets away from traditional asset management firms at a record pace. The Fidelitys and Franklin Templetons have reluctantly brought down their fees over time.

Academic studies have proven Bogle's point for over four decades. In 1974, Nobel Prize winner Paul Samuelson published "Challenge to Judgment," arguing that there was no evidence that fund managers could systematically outperform the S&P 500 on a sustained basis.[70] Around the same time, Charles Ellis published "The Loser's

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Game,"[71] which found similar evidence, while Princeton professor Burt Malkiel called for the creation of a mutual fund that mirrors the market in his seminal book *A Random Walk Down Wall Street*, first published in 1973.[72]

Retail investors are better off putting their savings into passive, indexed funds, which simply replicate the performance of a stock index, rather than "active" fund managers that pick stocks. Why pay for expensive fund managers when the index they are supposed to beat outperforms them? The more vexing question is why did it take so long for Bogle's idea to become mainstream? "Too much salesmanship, not enough stewardship," according to Bogle: Marketing, rather than investment management, has become the asset management industry's core strength.

Empirical research suggests that a large proportion of the compensation differential between the finance sector and the rest of the economy comes from rent extraction, or the act of obtaining economic gain by extracting value from society rather than creating new wealth.[73] Value extraction can appear in various forms, including excess fees. One of the most thoroughly documented examples comes from the asset management industry. Bogle stood out in his zeal to buck that trend.

Not everyone was enamored. From the time he launched his first index funds and was denounced as "un-American" on posters sponsored by a competitor firm, he never had a particularly warm relationship with finance industry leaders. That's not surprising, considering that his life's mission has been to call the industry's bluff on fees. A relentless champion of small investors against the system, he publicized the self-serving interests of active managers.

Some simply resented the "holier than thou" tone of his message. His energy and missionary zeal tended to translate into a tyrannical disposition at work, by his own admission. Perhaps this explains the frosty relationship he had with some of his successors at the helm of Vanguard. Clashes mounted when he came back to work after a heart transplant at age 67, implausibly reinvigorated after years of diminishing health. Boardroom drama forced him off the board, after which he was exiled in a corner of the executive building on Vanguard's campus. From there, he proceeded to push his industry agenda.

Bogle gave away his equity to his customers when he created Vanguard as a mutual company. This means that all of Vanguard's profits go back to its customers, the owners of Vanguard funds, thereby reducing

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their fees and ensuring that no traditional Wall Street firm could sustainably challenge Vanguard on a cost basis. By doing so, Bogle also effectively forwent vast wealth. He insisted that never in his wildest dreams could he have imagined Vanguard managing over $5 trillion as it does today. He was very wealthy by any absolute standard, but his wealth was very modest by the standards of the finance industry for someone who founded and managed one of the industry's behemoth institutions. That fit his character. In discussing his lifestyle during lunch right before talking to my students, he pointed out how he had owned the blazer he was wearing for more than thirty years. "Why buy another one?" Bogle asked. He systematically gave away a large chunk of his compensation, funding scores of Blair Academy and Princeton students over the years.

Bogle cringed whenever he was asked whether setting up Vanguard as a mutual company owned by its customers, and focusing on low-cost index funds were meant as acts of public service. He typically retorted that they were tactical decisions, made purely to avoid triggering a non-compete clause with his former employer and to quickly gain market share. Yet Bogle's pattern of decisions throughout his career and his lifelong crusade on behalf of individual investors point to broader motivation. At times, he described himself as an academic masquerading as a businessman. A better description might have been a public servant masquerading as a businessman.

A sub-theme of the course I teach on ethics in finance explores role models in the finance industry. They are few and far between. The challenge in discussing Bogle lies in the scale of his impact. By so effectively pressuring the asset management industry to lower its fees, he created more social good than perhaps any contemporary in the finance industry. He makes comparisons with other potential role models daunting.

The emphasis in this chapter on pioneers and change-makers such as Bogle should not create the impression that only those finance professionals that can have large-scale impact are worth emulating. In practice, most finance professionals, including those in entry-level and mid-level positions that do the bulk of the day-to-day work and interact with customers, can act virtuously and be helpful to society. Just about all employees of Vanguard, or "crew-members" as they are referred to internally, would do so, simply by enabling, in whatever small or large way, Vanguard's mission as a transparent, deeply customer-oriented and customer-biased financial institution.

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A Spartan Active Asset Manager: Dodge & Cox

Vanguard is a benchmark for the asset management industry that is difficult to replicate given its mutual structure and its enormous scale, which both contribute to lowering its costs. Still, other asset management firms have managed to exhibit fiduciary leadership. San Francisco-based Dodge & Cox is a rare asset management firm which forgoes all marketing and broker expenses in order to focus its resources on stock-picking activities and offer lower fees to its clients. Typically described as disciplined, sober, and long-term oriented, the firm has maintained a bare-bones structure, with no sales force and no overseas offices.[74] As a result, its fees are on average about 50% lower than its active asset management peers. Since its founding in 1930, the firm has shown unfashionable restraint, offering a very small array of mutual funds – six at last count, and closing some of its funds to new investors. It has steadfastly avoided the temptation to launch new funds to capture demand for the hot investment trend of the moment.

Entirely owned by its current employees, the firm has remained independent and private, allowing it to minimize conflicts of interests. Shareholder employees who reach 65 years of age are asked to start selling back their shares, in a structure that is reminiscent of Wall Street partnerships of a bygone era.

Its strong fiduciary culture has fostered employee turnover that is among the lowest in the industry. Perhaps to prove the point, co-founder of the firm Morris Cox came to the office until he was 95 years old.[75] Dodge & Cox hires only one or two new research analysts a year and once hired, they tend to stay. In fact, every member of the firm's Investment Policy Committee has started at Dodge & Cox as an analyst. CEO Dana Emery has spent her entire career at the asset manager, coming in as an analyst thirty-four years ago after being a varsity swimmer at Stanford. Among her priorities as CEO are to maintain the culture that emphasizes client focus, frugality, a low profile, and a long-term approach. She and Chairman of the firm Charles Pohl speak with reverence of the firm's co-founders, referring to them as Mr. Dodge and Mr. Cox, in a nod to the firm's explicit positioning as an old-fashioned, values-driven organization.[76]

Dodge & Cox stands out as a fiduciary leader in an industry that has increasingly played defense, as widespread underperformance relative to benchmarks has driven massive flows of funds from active to

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passive asset management. Asset managers are typically compensated on the basis of fixed annual management fees, at times in addition to an upfront sales fee. The emphasis on a fixed management fee implies that fund managers are rewarded for being asset gatherers. Of course, performance plays a critical role in a manager's ability to attract funds, but with many asset management funds acting as "closet indexers," deviating little from their benchmarks, marketing takes on a significant role in the vast majority of funds, Dodge & Cox being a rare exception.

In order to differentiate themselves, a very small but growing number of funds have experimented with so-called fulcrum fees, which reward managers when they beat their benchmarks and penalize them when they underperform it. San Francisco-based Orbis Investment Management has introduced an investor-friendly performance fee on several of its flagship funds. It charges a 0.45% annual management fee and a 25% fee on any profits generated above the MSCI World Index, but if it underperforms that benchmark, it will reimburse 25% of that underperformance from the fees it generated from the prior outperformance. It does so by putting into a reserve fund most of the fees it generates from outperformance since they can be clawed back. Founded in 1989 out of South Africa's largest private asset manager, it manages $35 billion as of mid 2019. The fulcrum fees it offers fit well the firm's positioning as a fundamental, long-term, contrarian investment manager. Anecdotal evidence suggests that its clients have been stickier during periods of underperformance as a result of this mechanism.[77]

Fidelity and AllianceBernstein have recently offered similar fee structures on selected funds. Fidelity has structured its fulcrum fees on three-year performance relative to the benchmark in order to address the concern that excessive risk may be taken if a fund manager focuses too much on annual outperformance. Still, these innovative fee structures remain a small niche of the industry – an estimated $1 trillion out of a total of about $14 trillion of assets under management for the US mutual fund industry as a whole.[78]

Japan's Herbivores: Haruhiro Nakano, Ken Shibusawa, and Hideto Fujino

The dynamics in Japan are altogether different, with many Japanese reluctant to invest in a stock market that has yet to recover to its peak of the late 1980s. Over the last two decades, a group of three mission-driven fund managers have taken on the fight to convince Japanese

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individuals to invest in equities for the long term and focus on costs. They articulated their philosophy in a book titled *Herbivore Investing – Taught by Professional Asset Managers*, which they published in 2010. The herbivore moniker is meant to facetiously invoke the passive nature of certain Japanese men, referred to as "herbivore males," in the presence of women, and symbolize the opportunity represented by long-term, low-cost, buy-and-hold strategies, even if they are not particularly fashionable.

Similar to the experience in the United States, the push toward lower fees has faced strong resistance within the Japanese asset management industry. Haruhiro Nakano endured years of setbacks at financial firm Credit Saison in his attempt to get the company to offer a product that emulated what Vanguard offered in the United States. A former high-yield bond and derivatives trader, he experienced a conversion of sorts, coming to the view after more than a decade working in capital markets that his job created little if any social value.[79] By age 40, he became driven by the need to "do an honest form of asset management."[80]

Japan's herbivores found critical support from Atsuto Sawakami, a highly respected investor who offered Japan's first low-cost independent mutual fund in the mid 1990s. One of the highest-profile investors in the country, Sawakami has acted as a mentor to the three members of the group. At age 70, he continues to give numerous seminars on the benefits of long-term investing, railing against the short-term biases of the investment industry. When Nakano found himself once again overruled by a new boss at Credit Saison, Sawakami met on several occasions with Credit Saison's board members and CEO to extol Nakano's project.[81] After years of rejection, Nakano finally prevailed and convinced his firm to offer the Saison Vanguard Global Balance Fund, starting in March 2007.[82] With no sales commission and 0.47% management fee, the fund's cost is less than half the average for the industry. He also offers an actively managed fund, the Saison Asset Building Tatsujin Fund, with no sales commissions and 0.54% management fee. By comparison, its peer funds average 2.6% in sales commission and 1.4% in management fees. Both of Nakano's funds have outperformed the vast majority of retail funds offered in Japan.

A similar mid-life pivot led Ken Shibusawa, the former Japan head of global macro fund Moore Capital, to work toward helping retail investors manage their savings with their best interest in mind.

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With no sales commission and 1.15% management fee, his Commons 30 fund also has a significantly lower cost than its peers. Shibusawa admits that his commitment to offer a low-cost, long-term-oriented fund has taken a toll on his personal financial standing.[83] The sense of mission runs strong in his family – his great-great grandfather, Shibusawa Eiichi, was a pioneer in the establishment of Japan's financial system, discussed in the introduction of this book.[84]

The third herbivore, Hideto Fujino, also had a pedigree background in asset management – with stints at Nomura, Jardine Fleming, and Goldman Sachs – before launching his own company, which more clearly reflected his values. That entrepreneurial streak leading successful investment professionals to leave well-established firms is much rarer in Japan than in the United States or the United Kingdom, making Shibusawa and Fujino true stand-outs, particularly since their purpose was to establish low-cost, values-based organizations.

These fiduciary leaders have found strong support from the Abe government. Nobuchika Mori, head of the powerful FSA between 2015 and 2018, took on as a mission the battle to sway individual investors toward longer-term, low-cost investing. He worried about the toll of having too much of Japanese household savings parked in cash and deposits – 51.7% versus 13.7% for US households, which goes a long way toward explaining why US household savings grew 3.3× in 1995–2016 versus only 1.5× for Japanese households.[85]

He was also appalled by the self-serving nature of the asset management industry in Japan. He asked rhetorically whether asset management businesses reliant on high fees "deserve to be preserved in our society" and whether they are "providing their employees with worthwhile jobs."[86] In a country feeling vulnerable about the plight of its aging population, he also questioned what "financial institutions selling unsuitable products to the elderly look like in the eyes of their children."

In 2017, he announced an investment program that allows individuals to invest tax-free up to ¥400,000 (about US$37,000) in equities and bonds for their retirement. The catch for the asset management industry is that only those funds that are low cost, unlevered, and with a long-term horizon can participate. He made his point clearly: as of November 2017, only 50 out of 5,400 funds were deemed eligible by the FSA. That number rose to 141 as of early 2018, as traditional asset managers introduced new funds to meet the criteria.[87] The end goal for

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the Japanese government is not only to bring down fees which have been charged, in Mori's words, "with little regard for customers' interests," but also to sway households to move their dormant $8.0 trillion in cash and bank deposits into more productive uses.[88]

A Rare Beacon in an Industry in Need of Fiduciary Leadership: The Watermark Group

Hedge fund management has been commonly referred to as the most overpaid profession in the history of the world, and it's hard to find many people outside of the industry that would disagree. The press regularly reports on the seemingly obscene amounts made by the leading hedge fund managers, often denominated in hundreds of millions of dollars, if not billions. These numbers reflect a business model that combines a relatively inflexible fee structure linked to assets under management (AUM) and the ability of a small group of investment professionals to benefit from gigantic scale effects. The typical fee structure pays fund managers an annual management fee of 1% to 2% of assets under management and 15% to 20% of all annual profits.

As a hedge fund's AUMs scale up, its management fees tend to increase linearly, while the costs of running the fund's operations typically don't come close to increasing commensurately. Potential incentive fees also increase with AUMs, although not in a linear way, as increased scale tends to have a negative effect on investment returns. A hedge fund typically revolves around a central figure who has developed an ability to generate alpha, i.e. returns in excess of the portfolio's market risk. A firm is created around the talented investor or group of investors, by encapsulating in a pithy manner the alpha-generating investment approach in its marketing message and by building a supporting group of analysts, traders, finance, back-office, marketing, and investor relations professionals. For many hedge funds, ramping up assets under management from, say, $1 billion to $3 billion triples management fees and greatly increases potential incentive fees, without requiring a massive increase in infrastructure and personnel. This can lead to large excess management fees at the end of the year, regardless of performance, since downward adjustments to management fee terms are seldom proactively offered, unless performance deteriorates to the point where fee discounts can be used to entice investors to stay.

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Why are investors in hedge funds willing to pay such steep fees? Various reasons have been proffered. One theory goes that the mandate of hedge funds – to generate excess risk-adjusted returns that are uncorrelated – plays a critical role in the management of a pool of savings, and pursuing that objective requires a specialized and rare skill set for which institutions and wealthy individuals are willing to pay. Yet hedge funds failed to perform when they were most needed. During the market meltdown of 2008, they generated 23% of losses on average, while global equity markets declined by 40%. Even putting aside the financial crisis, the hedge fund industry has had increasing difficulty in generating alpha over the years, perhaps not surprising given the more than eighty-fold increase in the industry's assets under management between 1990 and 2017. Contrary to expectations, fees have only declined from an estimated average of 1.6% management fee and 20% incentive fee in 2008 to 1.5% management fee and 17% incentive fee – far from the 1% management fee and 10% incentive fee that *The Economist* predicted in early 2009.[89] One reason may be that hedge fund investors decided to apply their increased bargaining power to secure better liquidity from hedge funds as a condition of investing, having been burned in the aftermath of the financial crisis by a wave of hedge funds "pulling up the gate," or ceasing to honor redemption requests to wait for better markets, because the fine print in their foundational documents allowed them to do that.

The slight improvement in fees doesn't make up for the fundamental asymmetry that underpins the compensation of hedge fund managers. Every year, they keep an average 15% to 20% of profits on the assets they manage. When they lose money, the losses must be recouped before they can earn incentive fees again. The asymmetry stems from the fact that fund managers earn, without recourse, incentive fees on gains in any given year, but provide an IOU to their investors when the returns are negative. Theoretically, if an investor stays in a fund that has generated losses, the fund manager should be able to steer the fund to climb back to its "high-water mark" over time. In practice, however, that is often not the case as hedge fund managers may not reach their high-water mark again and may decide to shut down their fund in light of the lack of prospects for generating incentive fees. Alternatively, their investors may decide to redeem from the funds, despite the fact that they have paid incentive fees over the life of their

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investment in the fund that are much greater than the nominal incentive fee as a percentage of profits that was advertised.

Other aspects of hedge fund terms point to a skewed relationship. While hedge fund investors are willing to pay high fees for alpha, much of the returns hedge funds generate are in the form of beta, or market risk, to which investors can gain exposure for minimal fees via index funds or exchange-traded funds (ETF).[90]

One constraint that is easy to dismiss from outside of the industry is the organizational effect of fee-related decisions made by a firm's leader or its senior partners. By making a decision to charge lower than standard fees, a hedge fund manager reduces the available pool of compensation in a way that is highly transparent to the rest of the employees. The lower fee may benefit the organization in the long term by creating better alignment with its investors and more goodwill and trust, but the most direct near-term effect will be a reduction in the compensation pool. The challenge is to attract and retain employees who were not recruited under the premise that their fund would innovate with non-standard fees but whose value to the organization tends to increase along with their ability to move to other, potentially better-paying funds.

One of the few hedge funds that has survived for more than three decades, the Princeton, New Jersey-based Watermark Group discussed in the first pages of this book, happens to be the only true fiduciary leader I have encountered in the industry.[91] It was co-founded in 1988 by Andy Okun and Stephen Modzelewski, who had both worked at Salomon Brothers' fixed-income arbitrage group in its heyday. Intent on creating a hedge fund fundamentally aligned with the interests of its clients, they did what just about no one else in the industry does: create a structure that is purely about ensuring symmetry between the fund manager and its clients, rather than referencing what is standard or acceptable in the industry.

That structure echoed the fulcrum fees seen in a small number of funds in the mutual fund industry, which we discussed above. A meaningful difference, however, is that US securities laws require mutual funds to create that symmetry if they want to charge a performance fee in addition to their management fee, while no such regulation affects the hedge fund industry – the likely reason why Watermark remains the only hedge fund manager I have found that offered such symmetric structure. A very small number of hedge funds have offered

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"first loss" terms – for instance, the Singapore-based investment manager for the Vulpus Kit Trading Fund will absorb up to an annual 2% of losses before the client experiences any losses.[92] But none of them offer the unadulterated reciprocity that Watermark used to offer.

Between 1990 and 2009, the vast majority of Watermark's incentive fees went toward building a reserve fund. If and when Watermark incurred a loss relative to a hurdle, it would pay out to its clients a percentage of the losses equal to the percentage used to calculate the incentive fee, with the capital coming out of the reserve fund. In the event the reserve fund was entirely used up to pay fees on losses, Watermark's funds would revert to a traditional high-water mark mechanism, according to which Watermark would not earn an incentive fee until its clients were made whole again. Watermark reluctantly gave up its symmetric incentive fee terms in 2009 when a change in the US tax code prevented a fund manager's incentive compensation from being kept in the fund with deferred taxation. The mechanism to ensure symmetry no longer worked once the fund manager had to pay personal taxes on newly crystallized incentive fees slated for the reserve fund.

Still, Watermark, which today manages in excess of $1.5 billion, continues to stand out from a fiduciary perspective in several important ways, including in its unusual level of transparency – with the fund's daily net asset value shared with clients, its commitment to prevent unintended value transfers among investors by establishing a mechanism to fairly share across investors the costs of the portfolio's large bid-ask spread (for each position, the difference between the highest price at which buyers are willing to purchase and the lowest price at which sellers are willing to sell them), and its decision to cap its assets for close to a decade and even return capital when there was a lack of attractive opportunities at various times. It has also charged its clients a lower than average management fee, reflecting Okun's and Modzelewski's conviction that management fees should simply support the business and not become a source of profits.

Watermark's singularity comes across even in the fine print of its legal documents, the very place where its peers tend to pack terms detrimental to its investors. Look closely and you'll find that Watermark's high-water mark actually grows with interest or that it can't "gate" clients in the event of a market crash.[93] Almost none of these investor-friendly terms were requested by investors, who tend to have an ingrained bias in favor of standard terms.

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Since the firm's founding, one of Okun's golden rules has been that no one on his team should accept any of the benefits that brokers commonly extend to their hedge fund clients – whether a concert ticket, a round of golf, or an invitation to a benefit event. The incident discussed in the opening of this book, in which Okun asked an analyst to repay not only the face value but the scalp value of a US Open ticket he accepted from Lehman Brothers, reflects the intensity of Okun's personal insurgency against accepted industry practices and ways in which, one might argue, Watermark simply doesn't fit its own industry. It takes committed leadership at the top of a hedge fund organization to impose this kind of discipline, and a strong culture to attract and retain a high-quality team that is willing to accept lower pay, at least in the short term, and fewer perks, rather than move to another, higher-paying fund.

At Watermark, Andy Okun and his partners have built a team that appears to embrace the group's core values. Watermark's relatively uncommercial approach stems from Okun's visceral dislike of the industry's in-built rapaciousness. By making his and his co-founder's values central to the way Watermark's client relationships are structured, Okun has built a group in his image – distrustful of Wall Street and remote from it, deeply analytical, and academic in orientation, with many scientists among its employees, and a large proportion of PhDs. A consequence of the strength of those shared values has been unusually low turnover since 1988.

Could Watermark become a model for other hedge funds? The answer up to now has been: not unless they have to. Watermark is also an unlikely trend setter, simply because Okun shuns the spotlight (deeply averse to the limelight, he only agreed to sharing information for the purpose of this book once I convinced him that the book will barely sell).

Mission-Driven Fiduciary Leaders: Endowments and Pension Funds

The spirit behind the Watermark Group's fiduciary discipline is rare among hedge funds but common among endowments, pension funds, and other tax-exempt investment funds. The gap in fiduciary commitment between hedge funds and tax-exempt funds is notably pronounced in their cost discipline. The Commonfund Institute estimates that well-diversified endowments are typically run on a cost basis of between

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1.00% and 1.75% of assets under management.[94] Since endowments typically allocate their capital to outside investment managers, much of these costs go toward compensating these managers. An analysis of the cost structure of nine diverse US university endowments based on data requested by Congressional committees in 2016 showed an average 0.20% of AUMs in internal costs and 1.24% of AUMs in external costs (largely fees to outsider investment managers), for a total of 1.43% in total average costs.[95] It suggests a significantly leaner cost structure than for hedge funds, even if the comparison is not apples to apples, since hedge funds have a direct investment model.

A critical difference is the fact that tax-exempt institutions are spending their own money when running their operations and are thus naturally disciplined, as opposed to hedge funds, which, by and large, manage "other people's money." Visiting a pension fund in Missouri, I was impressed by the fact that it had an internal process to approve the purchase of sandwiches for a working lunch – a far cry from the typical culture at hedge funds. The bureaucracy may be tedious on a day-to-day basis, but these types of cost controls instill discipline, align employee behavior with the organization's mission, and ultimately reflect a strong fiduciary culture.

The lower costs to run large pools of capital in the tax-exempt sector can also be ascribed to greater transparency and oversight relative to for-profit funds. That translates into lower compensation for key personnel, including their investment professionals. A common anecdotal observation about investment managers in the tax-exempt sector, particularly with endowments of universities and foundations, is the prevailing sense of mission. The clear linkage between investment returns and their use toward socially beneficial activities helps attract individuals who are not predominantly motivated by building up the size of their net worth.

As arguably the most respected and heralded chief investment officer (CIO) in the endowment industry, David Swensen epitomizes the mission-driven character of many of the professionals in the tax-exempt investment world. After six years on Wall Street, Swensen was tapped at the young age of 31 to manage Yale University's endowment in 1985. Over the past thirty-three years, he has developed in partnership with longstanding colleague Dean Takahashi the widely emulated Yale Endowment Model and has achieved a stellar investment track record. His Endowment Model consists of a structured approach to asset allocation with broad

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diversification. Critically, he was a pioneer in shifting his portfolio composition toward illiquid and alternative assets because he considers them to be less efficiently priced and to fit well an endowment's long-term horizon. That investment model has become the standard in the endowment world. Swensen and his team have delivered for Yale an industry-leading 12.5% average return per year over the past thirty years.[96]

In the age of compensation maximization, Swensen stands out for having steadfastly stuck with his position at Yale for more than three decades, despite his ability to make significantly more money managing private sector capital. He took an 80% pay cut when he moved from Wall Street to Yale and has since then turned down offers that would have generated multiples of his compensation, reflecting his enduring sense of mission.[97] Still, he makes a very comfortable living and acknowledges that he is paid very well for what he does, even if his compensation is but a fraction of his for-profit peers.[98]

Swensen appears to be motivated by a deep belief in Yale's mission, while harboring an emotional attachment to the school, having completed his PhD there, worked for two years as a freshman counselor, and lived on Old Campus, the heart of Yale College. He has taught full semester classes since 1980, and frequently gives one-off lectures or student talks. Two-thirds of his team have degrees from Yale, some of whom he recruited from his undergraduate seminar.[99] He has become a hero to the Yale Community, which is clear-eyed about the unique value he has delivered to the institution. In 2005, the Yale president at the time, Richard Levin, unveiled a chart at a party marking Swensen's twentieth anniversary at the university. It showed a list of those who had contributed the most to Yale going back to the school's founding, with names such as Beinecke and Harkness, which adorn some of Yale's most prominent landmarks on campus. On top of the list was Swensen's name. By that point, the university estimated that he had contributed $7.8 billion, based on his outperformance relative to other university endowments (that number had grown to $28 billion by the middle of 2017).[100] In the late 2000s, a campaign by a group of alumni sought to have Yale name a residential college after him to memorialize his contribution to the university. A full-page ad in the *Yale Daily News* asked "What Man Gives Up at Least $100M a Year to Work for Yale?"[101]

Swensen's sense of mission may also stem from his mother having had a strong influence on him. A mother of six, Grace Swensen

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became a Lutheran minister after all of her children went through college. Swensen considered the ministry when he attended college at the University of Wisconsin-River Falls.[102]

In turn, Swensen invests in investment managers that have, in his words, a "loose screw," in the sense that they define success as generating the greatest possible returns rather than maximizing their own compensation.[103] He considers that group to be only a small subset of the industry. He has had a disproportionate influence on endowment management in the United States, not only through the proliferation of his investing model but also by having trained and mentored many of the industry's leading CIOs who started as part of his team at Yale – prominent examples include Andy Golden at Princeton, Seth Alexander at MIT, Peter Ammon at Penn, and Donna Dean at the Rockefeller Foundation, to name a few.

While Swensen stands out for his long-term performance and his influence on the industry, other CIOs share some of the same attributes. Scott Malpass has managed the University of Notre Dame endowment since 1989, generating over 10% average returns over the past two decades, helping grow the endowment from $425 million when he took over to $13 billion.[104] Under Malpass, the endowment has climbed from the 23rd largest in the United States to the 10th largest, enabling Notre Dame to transform itself into a highly competitive national research university. Like many other university endowment professionals, Malpass is deeply dedicated to his alma mater and, in his case, to the school's mission as a Catholic university. There is a significant religious dimension to Malpass' management, with close attention paid to the social responsibility guidelines of the US Conference of Catholic Bishops and monthly investment office masses.[105] The Notre Dame investment team is almost entirely comprised of alumni and has experienced very little turnover through the years. Malpass is also highly involved on campus, having created and taught several investment classes over the years.

Princeton's CIO, Andy Golden, also stands out for his longevity at the helm of one of the major university endowments and for his stellar track record. A philosophy major as an undergraduate, he first tried his hand as a professional photographer until he pursued a management degree at Yale, where he was hired by David Swensen and Dean Takahashi. Since 1995, Golden's skilled investment management has helped grow the Princeton endowment from $3 billion to

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$26 billion. Like Swensen, Malpass, and other supremely talented endowment and pension fund managers, he lacks no opportunity to earn multiples of his compensation in the private sector. Golden exhibits the strong commitment to nurturing talent – both among his external managers and his staff – that seems prominent among those at the top of the endowment field. Clearly passionate about the linkages between his work and the school's mission, he has been a highly engaged participant in my freshman seminar on ethics in finance for almost a decade.

As a result of Golden's distinctive long-term investment performance and generous giving by the university's fiercely loyal alumni, Princeton's endowment towers as the largest among US universities on a per-student basis. In recent years, the endowment has enabled students from families earning less than $65,000 to receive grants to cover full tuition, room and board, and for more than 80% of seniors to graduate debt-free.[106]

Emerging Fiduciary Structures in Private Equity: Cranemere and Cadre

Fiduciary concerns related to the private equity industry have been well documented. Over the years, private equity funds have introduced and made standard a slew of fees that are additional to their fixed management fee – typically 2% of assets under management – and their carried interest, the 20% of profits they typically take upon exiting an investment. Those additional fees can include transaction fees once an acquisition has been completed, investment banking fees when additional acquisitions are made on behalf of the portfolio company, monitoring fees that are meant to compensate private equity funds for the work they perform to improve operational efficiency, director fees to sit on their boards, and advisory fees to help secure new loans. For small funds that manage assets below a critical mass, these fees can enable investment professionals to sustain themselves. However, investors in private equity, also referred to as limited partners (LPs), generally consider them to be superfluous. For most funds, the standard management fees comfortably compensate ongoing operations, regardless of performance. These additional fees raise concerns about investment professionals receiving generous compensation even when they generate mediocre returns.

Disclosures around these fees have been discreet at best, leading to a perception that private equity funds are self-serving, in contrast to their stated goals and the long-term nature of their investment

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approach. An academic study estimated that as much as $20 billion in additional fees were charged to US portfolio companies by private equity firms between 1995 and 2014.[107] These fees are described in this study as "hidden" because they generally did not appear in the agreements that specify the fees charged by the general partner to LPs. They are typically defined once an acquisition is made, in a negotiation between the general partner of the private equity fund and the executives of the acquired company, who are by then quasi-employees of the private equity fund.[108]

The four largest leveraged buyout (LBO) firms (Carlyle, KKR, Blackstone, and Apollo) are estimated to have generated $2.5 billion in monitoring and transaction fees from portfolio companies between 2008 and 2014, in addition to $27.3 billion in management and performance fees. To provide a sense of scale, these incremental fees charged to portfolio companies were estimated to total 1.75% of these companies' enterprise value and 3.6% of their earnings[109] – not inconsequential numbers.

Given the large fees paid to private equity funds, some large US pension funds are contemplating building their own private equity teams to save on costs. Among those are the California Public Employees' Retirement System (CalPERS), the largest public pension fund in the United States, which paid close to $700 million in fees to private equity funds in the year ending June 2016.[110] A fraction of that cost could help build a private equity team with distinctive experience. Some Canadian pension funds have been managing internal private equity teams for two decades, resulting in a two-third cost reduction.[111] It is not yet clear whether they can perform at the level of the well-established private equity funds and whether the right model is to perform direct investments independently or, as is more often the case today, pursue primarily co-investments with the private equity funds in which they are invested as another way to reduce management fees, since co-investments typically require far lower fees than the traditional 2% of management fees and 20% of profits.

Not all private equity funds charge these additional portfolio company fees. Hellman & Friedman, a San Francisco-based private equity fund created in 1984, prides itself on having a strong fiduciary culture that stems from Warren Hellman, a co-founder. The firm's private equity funds forgo all fees incremental to their management fees and carried interest.

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Warburg Pincus is another example of a highly successful, long-established firm which has a policy of not charging deal, transaction, or monitoring fees. The firm has a large investment support team that provides consulting services to portfolio companies at no charge. The advice can pertain to capital markets, external communications, government relations, or shared services such as employee benefits. Since its founding in 1966, the firm has put significant emphasis on alignment of interests with its investors. By keeping things simple – having one line of business, market-based management fees to run the firm, and incentive fees to share gains, it can more easily maintain that alignment. The firm doesn't boast about its culture or about higher morality. By remaining private, it isn't swayed by the argument that capital markets put a higher valuation multiple on recurring fee streams, which has incentivized many of its successful peers to seek market listings and to add fee-generating businesses. The firm's roots in venture and growth equity also made it unnatural for it to assess fees on its portfolio companies in its initial phase. It has maintained that discipline, even as late-stage control deals have come to represent a significant portion of the portfolio. When Warburg Pincus partners on specific deals with other private equity funds that impose monitoring and other fees on their portfolio companies, it has negotiated a larger equity piece from its partner rather than impose the same fees on the portfolio company.

An innovative approach to private equity structure and fees was developed by Vincent Mai, a leading figure in the private equity world for several decades (and, for full disclosure, the co-founder of the family office that seeded the fund I work in). Mai was profoundly affected in the initial phase of his career by his mentor, Sir Siegmund Warburg, the founder of the London-based investment bank S.G. Warburg & Company. According to Mai, Warburg passionately believed that one's reputation was everything and that money should always be a secondary concern.[112] Mai went on to become a partner at Lehman Brothers, when the firm was private, and led for more than two decades AEA Investors, one of the early private equity funds, backed by S.G. Warburg & Co. and the Rockefeller, Mellon, and Harriman families.

In 2011, he created Cranemere as a long-term fiduciary that seeks to address some of the structural weaknesses of the private equity model by adopting a "buy, build and hold" strategy for its portfolio companies. This model eschews the value destruction inherent in prematurely selling companies in order to conform to the time constraint of

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traditional private equity vehicles. Research by Bain & Company suggests that a long-term-hold model can generate almost twice the performance of a traditional private equity fund structure based on the theoretical difference between holding a company for twenty-four years and buying and selling out of four successive, equally performing companies over the same time horizon.[113] The delta in performance stems from the elimination of the frictional costs of constantly buying and selling companies, deferred taxation of capital gains, a more fully invested portfolio, and greater flexibility in exiting at the opportune time rather than when investor terms dictate it. With Cranemere's unusual model, Mai seeks to acquire good companies "forever," letting his investors sell their Cranemere shares to others if and when they decide to leave.

While the model incorporates Mai's beliefs regarding how to achieve better performance, it also explicitly embeds fiduciary values at the core of the organization by, among other things, extending governance rights to the shareholders.[114] Rather than the standard structure separating the investment management company from the fund, Cranemere was formed as a holding company, in which investors are shareholders rather than LPs, and are invested side-by-side with the management team.

The model also reflects Mai's deeply ingrained view that there is value in moderation. In a marked departure from the rest of the industry, the firm operates on a cost basis, meaning that the board must approve a budget annually on behalf of the shareholders, leaving no room for unwarranted compensation from excess management fees or undisclosed fees. This implies that Cranemere professionals can do well financially but over a longer horizon than would be the case at more traditional private equity funds.[115] Still, Cranemere has attracted high-quality talent, likely due to the combination of strong fiduciary values at the core of its model and the distinguished pedigree of its founder and top managers.

Other innovative models have emerged to help lower fees. Ryan Williams, a 31-year-old African American entrepreneur, created Cadre, a "fintech" platform that seeks to upend the real estate private equity industry by offering a US real estate investment product of similar quality to the leading private equity funds at lower fees and with greater transparency and flexibility. During his time working at Goldman Sachs and Blackstone, Williams noted the private equity industry's

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pronounced inefficiencies resulting from its clubby, relationship-driven deal-making environment and its multiple layers of fees, notably those of the private equity investment manager and of the operating partner. He believed that the industry was ripe for a new model, to be enabled by technology.

Cadre creates for its investors transparency and accessibility by offering them the ability to purchase a slice of any of the commercial real estate opportunities it offers on its online platform. It provides investors all the necessary data to make an informed decision, including extensive statistics, qualitative information on each building for sale, and drone videos of the properties and their amenities.[116] Investors can pick and choose on a deal-by-deal basis. Cadre offers this product at fees that are more than 30% lower than standard real estate funds, by charging a lower than market reporting and asset management fee (typically between 1% and 2% of net asset value), an upfront transaction fee typically 1% or lower of the cost of purchasing the building spread across all the investors that decide to buy a piece of it, and an incentive fee for its operating partners (which doesn't go to Cadre) of between 15% and 25%, rather than the standard duplicate 20% incentive fees for the investment manager and the operating partner.[117]

For a venture led by a young entrepreneur in an industry that has been dominated by the same set of companies for decades, Cadre has managed to attract highly established industry leaders, including the former CEO of Vornado Realty Trust, who also serves as Chairman of Cadre's investment committee. The value proposition of a new, flexible, transparent and lower-fee model has driven Cadre's rapid success in attracting investors. The early backing of a few high-profile industry leaders gave it enough credibility to overcome investors' bias for standard private equity models.

Cadre also offers investors the ability to exit their investments earlier than the five- to ten-year horizon of the traditional private equity model. It does so by creating an internal secondary market with an option to exit starting at year two. Over time, the resilience of an innovative illiquid asset platform such as Cadre that relies on a secondary market will need to be tested against the vagaries of a sharp economic slowdown. Early indications are that the combination of Cadre's innovative platform and Williams' ability to assemble a group of world-class real estate investment and technology professionals and

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backers could present a real competitive threat to traditional real estate private equity funds.

While Cranemere and Cadre signal a growing trend in the private equity industry, lower-fee models are still few and far between. One noteworthy development has been the extent to which the private equity industry has cut back on undisclosed fees after complaints by investors and increased involvement by the SEC. Following the Dodd-Frank Act, the SEC created a private equity unit in 2012 to monitor the industry more closely. Its initial targets included undisclosed fees and expenses, the misallocation of "broken deal" expenses, and the failure to disclose conflicts of interest. Some of the largest private equity firms, including KKR and Blackstone, ran afoul of the SEC's effort to create more transparency. This has spurred more stringent standards. Blackstone, for instance, announced in 2014 that it would no longer take accelerated monitoring fees when it completely exits a portfolio company in a private sale.[118] Close to 75% of North American buyout funds now offset most or all undisclosed fees against management fees.[119] While these fees are increasingly being offset, they remain popular because they help reduce stated fees and thus boost reported performance.

A Heroic Form of Fiduciary Leadership: Alayne Fleischmann, Paul Moore, Eric Ben-Artzi, and the Lonely Path of Whistleblowers

Whistleblowers often risk their careers, reputations, and livelihoods in order to alert authorities about wrongdoing at their firm, typically after having failed to trigger remedial action via internal channels of communication. Once they uncover malfeasance and try to capture the attention of senior managers, they often get either ignored or reprimanded. Once they go public, they are often ostracized by their former colleagues and the rest of the industry. For most whistleblowers, it is a thankless path.

Alayne Fleischmann fits the mold. She provided US federal prosecutors evidence that led to a $9 billion settlement by JP Morgan Chase. Fleischmann's early career interests leaned toward human rights and public international law but she decided to enter the securities industry after graduating from Cornell Law School in order to pay back her student loans.[120] She soon developed an affinity for the work and was hired by JP Morgan Chase in 2006 as a transaction manager. At the

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peak of the mortgage market at the time, US banks were frantically buying mortgages in order to repackage them into securities whose senior tranches routinely garnered AAA ratings, signaling their lack of risk, at least in theory. Fleischmann's role was to control the quality of the mortgages that JP Morgan Chase purchased for securitization.

Things started unravelling when the bank hired a new diligence manager in charge of approving loans. That manager asked Fleischmann and her colleagues to stop communicating with him by email, a red flag in an industry subject to heavy compliance requirements. By late 2006, Fleischmann and her colleagues were asked to audit a $900 million package of mortgages that Chase was contemplating acquiring from GreenPoint, a mortgage originator. It quickly became apparent that many of the loans were problematic. The mortgages were unusually old – many of them seven to eight months rather than the typical two to three months, as mortgage originators typically look to pass on their mortgages as quickly as possible. Fleischmann took it as a likely sign of defective loans – loans that had been rejected by other banks or in early default. Delving deeper into a subset of mortgages to check their quality, Fleischmann and her colleagues found that 40% of them were based on overstated incomes. Although the threshold of acceptable error rate for Chase was typically 5%, the loans were cleared.[121] Fleischmann approached a managing director to have the purchase reconsidered but she was ignored. She sent a letter to another managing director detailing the situation. Despite her objections, the loans were bought, repackaged, and sold to investors without appropriate disclosures on their likely impairment.

A 2011 lawsuit by a group of credit unions against Chase provides some color on how defective the GreenPoint loans turned out to be. One credit union had invested $135 million in a pool of mortgage-backed securities, 40% of which came from the GreenPoint loans. According to the lawsuit, losses amounted to $51 million in the first year, almost fifty times its projected losses.[122] While it's impossible to say how much of these losses stemmed from the GreenPoint pool, it is not a stretch to imagine that it was an important driver.

Fleischmann was laid off in early 2008. She was contacted by the SEC in 2012 regarding an investigation targeting another Chase deal. Keen to expose the financial misconduct surrounding the GreenPoint case, she enabled the government to pursue JP Morgan Chase. In November 2013, the bank reached a $9 billion settlement. While the

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face value was large, Fleischmann was at a loss. No executives were criminally pursued, the bank did not admit to wrongdoing, and the fine extracted value from the shareholders, not from the perpetrators. That prompted her to go public with her story by reaching out to a journalist from *Rolling Stone* Magazine.

Since being laid off, Fleischmann has struggled to regain her footing, as is typical for whistleblowers. Several law firms turned her down after she disclosed that she could be a witness against Chase. Her situation was compounded by the fact that she lost her job in the middle of the Global Financial Crisis. She went back to Canada and worked as a legal intern at a law firm in Calgary as part of the process to qualify as a lawyer in Canada.

She is part of a cohort of whistleblowers who reacted to malfeasance in the run-up to the financial crisis, often related to the willful misrepresentation of mortgage securities. Her experience of being shunned by the industry and her related professional and personal struggles are common. Richard Bowen is Fleischmann's parallel at Citigroup. Convinced that Citigroup was misrepresenting bad loans, he repeatedly shared his concerns with the most senior levels of management and the board out of frustration and got fired. Michael Winston was a whistleblower at Countrywide Financial, one of the most aggressive mortgage originators. A managing director prior to being fired, he has talked about being "punished, isolated, tormented, financially harmed and ultimately dismissed."[123]

Similar dynamics linked to mortgage businesses in the run-up to the financial crisis occurred in financial institutions outside of the United States. Paul Moore was a high-profile whistleblower at Halifax Bank of Scotland (HBOS), one of the largest British banks. As Head of Group Regulatory Risk, he became an agitator internally to stop what he deemed to be irresponsible sales tactics. He was fired in 2004 and wrote a detailed memorandum to the UK Treasury Select Committee in 2009 to blow the whistle. He was partly vindicated when James Crosby, the HBOS CEO who had fired him, had to resign as Deputy Chairman of the UK's Financial Services Authority and give up his knighthood. However, Moore's story since his own firing has been one of addiction, depression, and suicidal thoughts, as he revealed in his 2015 memoirs.[124]

Fleischmann, Bowen, Winston, and Moore's fates are typical: A study showed that 82% of named corporate whistleblowers end up

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being fired, leaving the firm under pressure, or finding their responsibilities altered.[125] Why do whistleblowers decide to pursue this path despite being cognizant of the limbo most whistleblowers have to settle for? Academic studies have shown that whistleblowers tend to be driven by moral considerations rather than personal gain.[126] In cases like Alayne Fleischmann's, that characterization resonates. She credits her upbringing: "I actually think it was because I came from a small town – Terrace, British Columbia . . . I just grew up with a value that a lot of people have – and that is, it's okay to do well, but you can't do that at other people's expense."[127]

The introduction of the SEC Whistleblower Reward Program under the Dodd-Frank Act of 2011 has brought in a significant potential financial reward. Whistleblowers can receive a financial award equal to 10% to 30% of the monetary sanctions collected in cases where they provide the SEC with information that leads to a successful enforcement action. Since its introduction, the program has led to $1.6 billion in financial sanctions and more than $387 million in awards to whistleblowers, as of the beginning of 2020.[128] Some awards have been enormous, peaking at $50 million for two former Merrill Lynch employees who exposed that the bank was misusing customer cash. Given its large awards, the program can eliminate for would-be whistleblowers the financial risk of being unemployable. It also enables them to enlist the help of expensive lawyers who can work for a percentage of a potential award. Yet studies of the motivation of whistleblowers in the pharmaceutical industry, which has awarded large financial rewards to whistleblowers for a longer period of time than the securities industry, suggest that even when they qualified for a potential financial reward, the ethical motivation was the most significant driver of their decision to blow the whistle.[129]

One awardee stands out for having turned down his compensation on the grounds that it was immoral to take the money. Eric Ben-Artzi was one of three whistleblowers who exposed improper accounting at Deutsche Bank in 2010–2011. A PhD in mathematics, Ben-Artzi was hired from Goldman Sachs as a risk manager. In assessing the risk in Deutsche's exposure to credit derivatives, Ben-Artzi gradually developed a view that the bank had inflated valuations by $12 billion at the peak of the Global Financial Crisis (the SEC estimated the overvaluation at $1.5 billion at the settlement with Deutsche in 2015). After actively raising the issue internally, Ben-Artzi was fired. He brought his

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case to the SEC and found out that at least one other whistleblower from Deutsche had gone to the SEC on the same issue. After Ben-Artzi got wind that the investigation might be shut down, he went public, sharing information with *Financial Times* journalists and writing an op-ed. The SEC eventually pushed forward the case and settled with Deutsche Bank for $55 million in 2015.

Ben-Artzi decided to turn down his share of the settlement between the SEC and Deutsche Bank, which amounted to $3.5 million (after deducting the share of the award to his lawyers and his ex-wife),[130] because it was taken from shareholders, who he perceived to be victims of a financial crime, rather than the managers who perpetrated the crime.[131]

Not everyone sees Ben-Artzi as a moral exemplar. Some have argued that his claims of fraud are far-fetched because the losses were paper losses which eventually went away and that there is a legitimate debate as to how to value the exotic derivatives at play.[132] They also perceive an attitude of moral superiority that they find grating. Still, Ben-Artzi is an intriguing, and even refreshing outlier. Examples of financial professionals who turn down large sums of money with no strings attached out of moral reasoning are rare, to say the least. He did not turn down his award because he didn't need the money. After getting fired, he could no longer afford his rent or his children's private school and moved to Israel after failing to find work in the United States.[133] He acted out of moral conviction, at a significant personal cost.

These examples point to various paths finance professionals can take to prioritize their customer mandate, which at times entail departing from the norm and forgoing some incremental compensation. In doing so, they fulfill their most important responsibility as professionals. But while that measure of contribution to society is critical, and arguably the most important, it does not capture comprehensively the impact of a finance professional on society. In the next chapter, we expand our definition of contribution to the collective good.

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