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Conflicts of Interest at Uptown Bank

In the spring of 2013, Associate Akash Ratik and his colleague, Executive Director Neel Metta, had just completed an internal strategy review within Uptown Bank Asset Management, a subsidiary of one of the largest U.S. bank holding companies, Uptown Bank. The review had focused on the relationship between two subsidiaries of Uptown Bank Asset Management: Uptown Bank Private Bank (UBPB) and Uptown Bank Mutual Funds (UBMF). (See **Exhibit 1** for an organizational chart.)

Uptown Bank's senior management initiated the review after recent news articles had questioned fiduciary investment practices within the asset management industry. UBPB, a market leader in U.S. private banking, managed over $100 billion of assets on a fiduciary basis for high-net-worth individuals. As a fiduciary, UBPB had ultimate discretion as to how client funds were invested, as well as a duty of care to act in clients' best interest.

The internal review suggested that UBPB disproportionately recommended and invested its clients' money in mutual funds operated by UBMF, otherwise known as proprietary investment funds. The review concluded that UBMF held a market share of about 5% at third-party banks while 50% of the client money held at UBPB, some $50 billion, was invested in UBMF mutual funds.

Effectively, Uptown Bank Asset Management was collecting two sets of fees from its clients: one, as a fiduciary private banking manager, up to 0.50% per annum (attractively priced compared to competitors, which typically charged up to 1.00% per annum);[1] and, two, as a mutual fund manager, ranging up to 1.00% (in line with competing funds).[2]

Only the fiduciary fees were readily apparent from client statements while the mutual fund fees were deducted automatically at the fund level—a common industry practice. In other words, the mutual fund fees were implicitly incorporated into the portfolio gains and losses and not explicitly detailed to clients. In addition, many clients of the private bank did not regularly review their statements, as the funds were often managed through third-party trusts.

Ratik, who had previously worked at several investment firms, found this dual-fee arrangement very bizarre, if not unethical, and concluded that there must be extensive legal documentation in support of the structure. Metta agreed that there was a clear conflict that should have been disclosed; however, Metta disagreed with Ratik beyond that. Metta told Ratik, "For me, this seems like a legitimate issue that should be remedied, not an Enron-like situation where the firm deliberately misled investors to make money."[3] In response, Ratik rolled his eyes and said, "Whatever, man." [4]

Professor Jonas Heese prepared this case. It was reviewed and approved before publication by the two case protagonists. The names Akash Ratik, Neel Metta, Alan Stone, and Uptown Bank are disguised. Funding for the development of this case was provided by Harvard Business School and not by the company. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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The Wealth Management Industry

Financial and Investment Advising

The U.S. wealth management industry consisted of various players, such as registered investment advisers, financial advisers, and brokers, all of whom received fees for directly managing client funds or advising as to how those funds should be invested. Potential clients included high-net-worth individuals, businesses, governments, and other organizations.[5]

Registered investment advisers served as fiduciaries, meaning they could make investment decisions on behalf of clients without first getting the client's permission; the U.S. Investment Advisers Act of 1940 required them to meet a *fiduciary standard* by acting in clients' best interests.[6]

Regarding the fiduciary standard, the U.S. Securities and Exchange Commission (SEC) wrote, "As a fiduciary, an adviser must avoid conflicts of interest with clients and is prohibited from overreaching or taking unfair advantage of a client's trust. A fiduciary owes its clients more than mere honesty and good faith alone. A fiduciary must be sensitive to the conscious and unconscious possibility of providing less than disinterested advice […]."[7]

Unlike registered investment advisers, financial advisers were not required by law to act as fiduciaries, but they were required to disclose the basis of the relationship.[8] Financial advisers often focused on retirement planning services and received fees in exchange for advising clients' on how to achieve their investment goals. Such advice could entail investing directly in stocks or bonds or through intermediary funds, such as mutual funds, that then invested the assets.

Brokers similarly provided financial advice to clients, but they also acted as sales representatives. Brokers typically earned commission-based fees if clients chose to invest in the recommended investments, which could include proprietary funds or third-party funds paying a percentage-based fee. Brokers were not explicitly held to the fiduciary standard but, instead, adhered to the *suitability standard*, a lower legal standard that dictated brokers should only recommend products or investments that were suitable for the client.[9]

In 2013, the financial planning and advice industry, which included registered investment advisers and financial advisers, generated an estimated $49.2 billion, with the top four players (Morgan Stanley, Wells Fargo, Bank of America, and Ameriprise) holding a market share of approximately 46%.[10]

In 2013, the U.S. securities brokering industry generated $107.3 billion in annual revenue and had grown 7% per year in the five years prior.[11] The top four players (Bank of America, Wells Fargo, Morgan Stanley, and J.P. Morgan Chase) earned about a third of total industry revenue.[12]

Regulatory Environment

The U.S. wealth management industry was highly regulated in an effort to prevent financial services firms from taking advantage of consumers. Much of the legislation that guided the industry arose out of the financial scandals and investor losses associated with the Great Depression of the 1930s.

The SEC acted as the primary enforcement agency for most asset management firms, particularly those that operated as registered investment advisers. The U.S. Investment Advisers Act of 1940, which banned "fraudulent, deceptive, or manipulative" practices, gave the SEC power to set more specific rules and to sanction those who committed violations.[13] (See **Appendix A** for an excerpt of the Investment Advisers Act of 1940 and **Appendix B** for the SEC's investment adviser guidelines.)

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In the wake of the Bernie Madoff scandal, the SEC initiated a rewards-based whistleblower program to source leads regarding misconduct in securities markets. The program was established as part of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). In addition, the Financial Industry Regulatory Authority (FINRA) oversaw the activities of brokerage firms while firms that employed both brokers and advisers were overseen by both the SEC and FINRA.

Financial services firms that offered asset management as one of many businesses were subject to oversight and regulation from other agencies, including the Office of the Comptroller of the Currency, the Federal Reserve, the U.S. Treasury Department, and the Consumer Financial Production Bureau. Many financial services firms also had to adhere to rules from state regulators, depending on where they operated and where they were chartered.

Potential Conflicts of Interest in the Wealth Management Industry and Disclosure Rules

The line between advising and brokering was blurry in many cases, since many financial services firms offered both services. By one estimate, 70% of brokerage firms were "dual hat" firms that also offered advising, due in part to acquisitions of advisory firms over the years.[14]

At *open architecture* firms, advisers and brokers typically helped invest their clients' money in whichever proprietary or third-party funds they judged to be best. *Closed architecture* firms typically invested all of their clients' money in the firm's own proprietary funds, sometimes offering lower overall fees than clients would pay with an open architecture firm.

Dual firm structures, incorporating elements of both open and closed architecture, faced criticism because of the potential conflicts of interest, especially since many financial advisers and brokers were not legally bound to the fiduciary standard. If firms could earn additional revenue by convincing clients to invest in proprietary funds, they might implicitly or explicitly direct employees to steer their clients' money toward those funds – even if it was not necessarily in clients' best interests.

In the mid-1990s, for example, a long-time stockbroker reported to the SEC that the entire brokerage industry took advantage of - and deceived - clients. The stockbroker alleged that his employer regularly incentivized brokers with contests and prizes, such as jewelry and vacations, in order to convince clients to invest in funds with higher fees.[15] He commented, "Would you want to go to a doctor who was trying to win a contest by writing certain prescriptions? The contests create a certain culture and it is detrimental to the consumer."[16]

In the mid-2000s, the SEC investigated Merrill Lynch over potential conflicts of interest related to its management of pension fund clients in Florida.[17] The SEC concluded that Merrill Lynch had breached its fiduciary duty, and the firm eventually divested its mutual fund business through a sale to investment management firm BlackRock in 2008.[18] In 2012, some of J.P. Morgan Chase's former brokers reported that the firm had pushed them to direct clients toward the firm's proprietary funds.[19] In 2013, Reuters reported that registered investment advisers from several wealth management firms had received payments from Charles Schwab and Fidelity in exchange for investing clients' money in their funds.[20]

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Akash Ratik and Neel Metta

Akash Ratik

Born to doctors who immigrated to the U.S. from India, Ratik grew up in an upper middle-class neighborhood. Though his parents held high expectations for him, Ratik described himself as an under-performing and rebellious high school student:

> I was the opposite of a model minority. Most Indian-American kids of my generation, at least the ones I knew, were very dutiful. They studied hard, went to great colleges, and generally became doctors. That seemed boring to me. Virtually all of their parents had come from challenging backgrounds in India, but my family was different – my father had grown up in a very wealthy and influential family.
>
> The Indian economic crisis of the 1970's had forced my father to come to the U.S., but, somehow, a mentality of privilege stayed on – I had a sense that whatever happened, I would be fine. That was, of course, not true at all but it did open my mind up to a lot of possibilities most people would not entertain, let alone pursue.

With high SAT scores but low grades, his goal of attending an Ivy League college was out of reach. Instead, he applied and was accepted to the United States Military Academy at West Point. Ratik had concluded it was one of the few schools where he would benefit from affirmative action; in his year, there were only three South Asian cadets in a class of 1,200. While he was not sure what the future held, he thought the worst-case scenario would be transferring to an Ivy League school.

Friends and family were surprised that he was admitted and, also, that he enrolled. His high school teachers even held a poll as to how long he would last. Ratik was a terrible runner and had previously demonstrated no inherent respect for authority, cycling through three high schools amid various suspensions. As a West Point "plebe" (freshman), he quickly gained the attention of upperclassmen for the visible shock he repeatedly demonstrated at the tasks he was ordered to complete.

After a number of demerits (disciplinary marks), he had to march through the dormitory halls in full parade uniform at 6:00 a.m. Another time, he was asked to write an essay on the importance of attention to detail and, rushing at the last minute, he somehow stapled the pages out of order after grabbing them from the printer. Ratik said, "I got yelled at all the time. I mean, I was practically famous for getting into trouble. Many people wondered what this lazy, entitled Indian kid was doing there. Some 'Firsties' (seniors) tried to get me to resign, but I don't quit easily. In fact, all of those crazy experiences serve to create real bonds with your classmates. I made great friends and was (generally) able to laugh at how ridiculous it all was. That said, a lot of people did not take me seriously."[21]

One semester, after moving to a new dorm room, Ratik realized that he had left a bottle of cannabidiol (CBD) supplements in the closet of his previous room. West Point had recently allowed such supplements on campus, and while Ratik had never used them, he thought they might help if he ever ended up going to the gym.

The room's new occupant, Alan Stone, said he hadn't seen the bottle, and Ratik went back to check his room again. After a thorough search, Ratik suspected Stone of lying and was determined to prove it. Ratik explained, "A cadet will not lie, cheat, steal, or tolerate those that do—that's the Academy's Honor Code and it's taken very seriously. It was clearly an issue of respect as well."[22]

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One day, while Stone was out, Ratik entered Stone's room, went through his belongings, and found the CBD. Ratik left the bottle there and later confronted Stone, who angrily insisted he had purchased it himself. When Stone could not offer any proof of this, however, the story fell apart. Stone ultimately apologized and listed various reasons as to why his family could not handle the fallout from a theft accusation. Ratik was suddenly placed in a very challenging and completely unexpected position. He reflected:

> It was tough. Stone obviously did something wrong and totally contrary to the school's mission. I mean, the Honor Code is like the first thing they tell you about. But, on the other hand, if you turn somebody in for something like this, they get kicked out.
>
> When you get into West Point, you are often celebrated by your community as being a great person, so getting kicked out for an honor violation, especially over something idiotic, is unimaginably difficult. It was hard to think through because everything rode solely on my decision and there was only one possible penalty, which was severe.
>
> To some extent, I wondered if it was my fault, as I was a mediocre cadet, physically underwhelming, and kind of an oddball. On the other hand, he was a popular athlete, a bit of a class clown, and was probably just trying to impress his roommates. He had no idea it could come to this.
>
> I wanted to be careful about not reflexively wielding this power out of anger. I mean, it was a huge decision. I had also started thinking about leaving the Academy even before this happened – so I wondered if I should just forget it and go my own way.
>
> On the one hand, I didn't think Stone was a fundamentally bad person – certainly immature, but not bad. He had made a stupid mistake, which happens to all of us. But, on the other hand, I also came to the realization that he chose to take advantage of someone he thought was weak. And that, to me, was simply wrong.
>
> I also have to admit, and this sounds crazy, that I spent a lot of time thinking: well, if I don't turn him in – would I always look back and think it was because I *was* weak? It's a little uncomfortable to admit this influenced my decision, but I decided I could not take the risk and that it was his fault for putting me in such a position – I told him to turn himself in or I would.
>
> It was brutal and, quite embarrassingly, I had some "crocodile tears" when explaining my decision to him. To his credit, once he understood my decision was final, he told me to get "the hell" out of his room and he dealt with the punishment.[23]

While Ratik considered staying at West Point, the aftermath of this incident—including physical threats from some of Stone's friends—made it clear it was time to leave. While his grades had improved, they were still not high enough for the Ivy League, so Ratik enrolled at Oxford University as a year-abroad student. He got top grades in all his classes and was invited to stay for another year. He graduated with First Class Honours, the highest academic distinction.

Ratik had always aspired to be a Wall Street banker, so, after graduating, he joined a boutique investment bank in New York City. There, he discovered he had a talent for connecting with senior-level colleagues, but he also struggled with maintaining focus on the often mundane tasks required of entry-level roles. Ratik said:

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> I had no idea what I was getting into; I thought the job was meeting clients and coming up with novel ideas – but that is the job for senior bankers. The ideal junior investment banker is respectful, manages their time efficiently, and demonstrates extreme attention to detail. I was a procrastinator who did things at the last-minute, often late into the night, and never checked for typos or anything.
>
> Also, I also could not believe how risk-averse investment bankers typically were; most have no idea how to invest personally, yet their job is to advise on multi-billion-dollar transactions. It's unbelievable. This is a little unfair, as there are some very talented bankers, but the job is more about shopping businesses (like a real estate broker) than actually understanding them. For example, of the hundreds of sell-side investment banking decks I've seen, every single one had expected earnings climbing dramatically.[24]

After learning that the firm did not plan to renew his two-year contract, which rarely happened, Ratik pursued and landed a job at a prominent private equity firm after reading about its success in the newspaper:

> I was amazed, as the article said the firm's founder made a billion dollars on one deal… personally. I immediately called a friend of a friend who worked there, and he arranged for me to meet a partner. The partner said he enjoyed meeting me, but the firm only had an opening in London. I said I was actually going to be in London next week—which I made up—and another interview was arranged. I took vacation, went to London, and got the job; everyone I worked with was shocked.[25]

Ratik added:

> It was very exciting stuff—a different world. I was 25 and flying around in a private jet. The press would sometimes follow us around, and the founder was on the front page of the *Wall Street Journal* and *Financial Times* every few weeks. Also, the firm had only two professionals in Europe, and we invested about $5 billion in financial services firms over two years. It was surreal.
>
> I was hoping to learn how to invest, but nothing we were doing was particularly intuitive to me at the time. I figured I just wasn't as smart as the people I worked for. Then the Global Financial Crisis hit; it was total chaos, and the firm ultimately lost several billion dollars. It was a powerful lesson that "all that glitters is not gold." I concluded the founder, a former star investment banker, was completely incompetent; we might as well have burned the money.[26]

Realizing the precariousness of the financial sector, Ratik resigned to pursue an MBA and graduated in 2010. Afterward, he joined what was then the largest hedge fund in the world, working directly for the managing partner, who was also a highly renowned billionaire. Ratik recalled:

> When I was a summer intern, the managing partner asked me to do an analysis on a company. I figured he was kind of mentoring me, but then he turned to the trader and told him to buy $100 million of the company's stock, based on my analysis. I almost died.
>
> It was an incredible opportunity, and I was excited to get my career back on track. Once I joined full-time, however, things took a turn for the worse. After an unprecedented money-making run, the firm's investment performance suddenly began to flag. Coupled with this, it became increasingly clear that disagreeing with the managing partner could be quite challenging and even potentially career-threatening.

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> I have to be careful about this because sometimes the discussion yielded very productive analysis – brilliant even – but at other times, there was a lot of pressure to simply agree. I chafed at this and, on at least one occasion, I got yelled at so badly by the managing partner that I was worried he might have a heart attack right then and there.
>
> More generally, I felt this dynamic was dysfunctional and undermined the firm's investment process. It was another surreal moment: I was a broke, 30-year-old research analyst, and I had concluded this multi-billionaire, world-leading investor had no idea what he was doing. I was very concerned for the firm yet felt completely powerless to do anything about it. I also could not believe this was happening again.
>
> I started scrambling for another job and received an offer from a large bank, albeit one that entailed a 50% pay-cut. It was depressing, as I was giving up on my life-long goal of being rich – but I was ready to get off the alternative investments roller-coaster.[a] In the five years after I left, the hedge fund's investor losses were staggering, the vast majority of the research staff quit or were fired, and the firm was ultimately converted to a family office.[27]

In early 2012, Ratik joined UBPB as part of its internal strategy group. Much of his day-to-day work involved putting together long slide decks about strategy topics, such as cost savings models, for senior management. Ratik found it tedious: "It was hard to make a lot of money there, which I expected; that's a reasonable trade-off for stability. What surprised me was that the people worked so hard, often staying past midnight, and were generally pretty capable."[28]

Despite the change, Ratik once again struggled, and his initial performance review rating at UBPB was "mediocre." He explained:

> I was surprised, as I thought my output was superior enough to justify my idiosyncrasies and generally flip demeanor. I had a unique skill set and could do things that other people couldn't, such as analyzing competing firms' financial reporting.
>
> My supervisor acknowledged this but said it did not matter: "Your attitude's bad, and unless you show some appreciation for being here, you're not going to be here for very long." I was shocked.
>
> A super-senior executive even told the group's executive assistant to tell me that I needed to stop laughing during meetings with senior executives—which made me laugh. When I responded, "Or what?," she said, "Or else." [29]

Ratik realized that the job was not a good fit and was beginning to wonder if his career was slipping away. He reached out to a contact at yet another financial services company to inquire about a job opportunity. In the meantime, his supervisor assigned him to help with an internal review of UBPB. Ratik said, "I basically told my supervisor I was going to leave, but he said I needed to work on this final project as the team was fully staffed."[30]

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[a] Alternative investments were supplemental strategies to traditional long-only positions in stocks, bonds, and cash. Alternative investments included investments in five main categories: hedge funds, private capital, natural resources, real estate, and infrastructure.

See https://www.cfainstitute.org/en/membership/professional-development/refresher-readings/introduction-alternative-investments#:~:text=Alternative%20investments%20are%20supplemental%20strategies,%2C%20real%20estate%2C%20and%20infrastructure.

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Neel Metta

Metta earned his Bachelor's degree from an Ivy League school, followed by a Master's degree. Before joining UBPB, Metta had spent several years working as a manager at a top consulting firm. In 2007, he became an analyst at a boutique investment firm, and two years later, he left to take a job in the Obama Administration.

After leaving his government role, Metta wanted to build a long-term career in asset management. Metta joined UBPB's internal strategy team in 2012, several months after Ratik. Metta planned to remain at Uptown Bank for at least a few years, though he noted, "I never saw myself there forever."[31]

Metta's role was one level more senior than Ratik's, and Metta had worked with Ratik for several months by the time they were assigned to the internal review. Metta knew that Ratik could be a challenging employee to manage. He recalled:

> On occasion, Ratik would disappear during the day and then come back in the evening to work all night. That kind of thing can be difficult in a corporate setting. He was unconventional and rebelled against authority, but he was also extremely bright. I would say he was uniquely capable of dealing with some of the more complicated projects and, also, several of the "complicated" senior people at the firm. He got things done in the end, but it was a long way from the beginning to the end.
>
> He also must have a very complex psychological profile; I have never seen anyone go so quickly from kissing ass (e.g., agreeing to an ambitious project timeline with senior management) to kicking it (back at his desk, when an analyst complained about the workload). I told him that he seemed to lack the filters that most people have. He does not seem particularly swayed by "authority bias," and there are just some ideas that pop into his head—both good and bad—that would not occur to or be expressed by most people.[32]

Despite the occasional friction about Ratik's work ethic, the two colleagues had a friendly relationship, and Metta was also assigned to help with the Asset Management business review.

The Internal Review

In the spring of 2013, a senior manager requested the Asset Management review. Recent media reports had spotlighted the industry, alleging that some financial advisers felt pressured to encourage clients to invest money in proprietary funds, creating conflicts of interest. Uptown Bank's Asset Management business had two divisions: UBPB, where private bankers oversaw fiduciary accounts; and UBMF, the fund management division, which sold mutual fund products.

UBPB, which managed $100 billion in fiduciary accounts, invested these funds across proprietary funds (i.e., funds owned and managed by Uptown Bank) as well as funds from third-party managers. As such, the Uptown Bank senior manager wanted to know if there was any reason to be concerned about the news articles.

Financial regulators had previously examined some of UBPB's asset management policies. One recent review found potential conflicts of interest in some areas and suggested that management alter existing internal controls. A review the following year similarly flagged potential conflicts of interest but found that, in general, UBPB had satisfactory oversight measures in place.

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The senior manager knew that UBPB used a framework called "guided architecture"—essentially using elements of both closed and open architecture frameworks—but, during his long career with Uptown Bank, he had never seen a precise definition of the term.

His understanding was that, in some cases, advisers would recommend proprietary products; in others, they would recommend third-party products. However, it was unclear to the senior manager whether there was a formal process for recommending proprietary versus third-party products. When a client invested in UBMF funds, the firm collected both the advisory and fund fees; when a client invested in a third-party fund, the firm only collected the advisory fee.

Ratik and Metta were part of a small team tasked with determining how UBPB defined guided architecture and whether it properly disclosed its approach to clients. Metta recalled, "From my perspective, our role was to examine the practices at UBPB with respect to use of proprietary products. How much proprietary product were our clients using? How did it vary by asset class? What were other firms doing? How did our practices compare to them? From a legal perspective, where were we on solid ground and where were we not?"[33]

With the buy-in of the senior manager, the team was able to move quickly. Ratik said, "Initially, no one wanted to give us the information, as it was very sensitive. But the senior manager told us, 'If you have any problems getting information, CC me on emails.' And, boom, the information would come back immediately."[34]

Ratik and Metta first reviewed UBPB's client documents but could not find any written policy defining guided architecture. They reported this to the senior manager, who then instructed them to review each product line to determine the percentage of clients' money invested in proprietary versus third-party funds.

Ratik and Metta determined that UBPB's private bankers, who acted as fiduciaries, disproportionately directed clients' money to proprietary funds, with some 50% invested in proprietary funds. In contrast, UBMF mutual funds typically comprised 5% of funds invested at other private banks. They also found that proprietary fund investments contributed significantly to Uptown Bank Asset Management's revenue—and had an even bigger impact on profitability.

According to Ratik, Uptown Bank Asset Management might collect a fiduciary advisory fee of 0.50% and an additional 1.00% in mutual fund fees if the client invested in a proprietary fund.[35] The marginal revenues earned from mutual fund fees were extremely profitable, as mutual fund costs were largely fixed. Revenue was among the metrics that Uptown Bank Asset Management used to evaluate its private bankers, creating an incentive for them to favor proprietary funds (see **Exhibit 2**).

Ratik saw all of this as a red flag:

> On the brokerage side, all of this nonsense is kind of allowed because the customer makes the final decision, but the fiduciary side is a fundamentally different business. There, the firm makes the final investment decision and, as such, owes a duty of care to its clients.
>
> It's unclear if those proprietary funds were the best option for the customer—they might have been—but you have to look at the mechanism to get to that fund. It's suspicious if Uptown Bank's products have an overall 5% market share, but 50% of client assets are invested in those products.

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> The idea that an unbiased selection process could generate that result, particularly with hundreds of millions of dollars at stake, seems absurd. Clients were affected and, in my opinion, clearly harmed.[36]

Metta saw it differently:

> First of all, the fee structure is in line with standard industry practice. Could advisers have found a better product that made clients more money? Maybe, but it's only possible to know that retroactively. Sometimes you can definitively say, "This is not a good product because the fees are too high or it performed poorly and the manager hasn't demonstrated skill," and, in those cases, the product should clearly be avoided. But sometimes it is difficult to make definitive judgments because distinguishing between poor performance due to lack of skill versus bad luck can only be done over long periods. If two products are not the exact same in terms of their underlying exposures, it becomes even more difficult to compare results.
>
> Furthermore, many product categories are commoditized, which means there is little or no difference to which product a client gets in that category. For example, the money market products offered by different banks are almost identical—so in that case, recommending a proprietary product, despite earning a fund management fee on it, is justifiable as it makes no difference to the client. As you move to other asset types, the dispersion in terms of outcome grows, and the bar gets incrementally higher to justify the use of a particular product. It's a problem if you know you have a bad product and recommend it to a client so you can make money on it at the client's expense, but usually it's not that straightforward.
>
> My interpretation is that, in most of the cases where the firm used its own products heavily, it didn't make much, if any, difference to private bank clients. They would have had to pay a separate fund management fee regardless of whether it was a proprietary or third-party fund, and the expected outcome in terms of performance was comparable. I'm not sure most clients would even care whether Uptown Bank or another bank earned the fees on the underlying products. That said, any conflict should be disclosed.[37]

Ratik completely disagreed with this:

> I think Neel's thinking on this is totally misguided. To me it is very clear: as a fiduciary, Uptown Bank should be investing its client assets in the client's best interest with no incentives to favor its product whatsoever. The portfolio construction being in any way guided by incentives to increase the bank's profitability, irrespective of the performance outcome, was simply wrong. Once you open the door, it would require inhuman amounts of discipline to act in clients' best interests.
>
> The only possible work-around to a guided architecture process would be a clear disclosure of what the firm was doing, how it was earning fees, etc. I believe fiduciaries can generally cure conflicts through disclosure; however, my sense is that these conflicts should be relatively minor and exceptions to the rule. Here, preference for proprietary product was the rule! I'm not a lawyer or anything, but it just didn't sit right. I felt the disclosures were the key to understanding how this all worked.[38]

Ratik and Metta asked UBPB's legal team about the firm's disclosure to clients about its guided architecture approach. The legal team said that there had been a disclosure stating that UBPB preferred

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to invest in proprietary funds where "appropriate," but it had been removed from client materials several years ago as the disclosure "raised more questions than answers," according to Ratik's recollection.[39] The disclosure had not been replaced, and there was no existing disclosure regarding the preference for proprietary funds at UBPB.

Ratik and Metta both agreed this was an issue that needed to be flagged to senior management. Metta noted, "The company was trying to identify and fix any disclosure problems, so the expected output of our review was to find gaps and be able to say, 'This disclosure is insufficient. Let's address it.'"[40]

The Discussion

Despite their disagreements, Ratik and Metta presented a united front in an initial meeting with UBPB's internal legal counsel team. Ratik and Metta detailed the various options for reducing or eliminating the conflict (e.g., selling the mutual fund business or simply not charging fees for proprietary funds). It was clear, however, that all these options would correspondingly reduce profitability. Toward the end of this meeting, Ratik concluded by saying, "We're not experts or anything, but given that UBPB is a fiduciary and there's no existing disclosure on how the firm profits from proprietary funds, it appears that the current guided architecture policy is illegal."[41]

As Ratik recalled, a legal department employee first told him never to use the phrase "illegal" again. The employee then added that it sounded like Ratik had misunderstood the purpose of his role—it was not to "opine" on an optimal policy but simply to defend the existing policy of guided architecture. Ratik nodded but was enraged inside. In his head, he said, "I think *you've* misunderstood…who *I* am." He recalled, "They basically told me that changing the structure of the business was not an option because it was incredibly profitable."[42]

Ratik and Metta were told that a revised presentation needed to be completed as soon as possible. Uptown Bank's General Counsel, who sat on the bank's Operating Committee, had been asking questions, and a meeting with him had been scheduled with the CEO of UBPB for the next morning. Ratik recalled that, prior to the meeting, the CEO of UBPB said, "We are not managing to the General Counsel; everyone at Uptown Bank takes risk; this is the type of risk that we take." Ratik said, "I could not believe it. I thought she was insane, idiotic, or both. I mean, she was talking about *regulatory risk*."[43]

Ratik's fury only grew. He told Metta, "These people are telling me to shut up when it's clear they are wrong."[44] At this point, Ratik was concerned that UBPB may have broken the law. As he understood it, UBPB, a fiduciary, was effectively self-dealing by selling proprietary products to its clients without disclosure.

Metta was surprised by the intensity of Ratik's reaction, replying:

> That was an unpleasant conversation, and I certainly was not going to do anything unethical, but I wouldn't take something a junior legal employee says as indicative of the way the entire organization thinks. The review was initiated at a very senior level, so I see this as a good-faith effort by the firm to find a resolution.
>
> If I had evidence that people were sitting in a smoke-filled room trying to cover this up, I would have a different view, but I see the opposite—people are trying to figure out what is going on and fix the disclosure issues.[45]

"You're out of your mind," Ratik insisted, adding:

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> It's totally in their interest to maintain the policy as long as possible. Fixing this would mean either selling off the fund business, diminishing the UBPB CEO's role, or fully disclosing the practice, which might well be illegal even if clients stuck around. The marginal revenues at stake, 1% mutual funds fees on $50 billion of fiduciary assets, are $500 million. Up to half of this is paid out in compensation, which means that most senior managers of UBPB make eight figures as a matter of course.[46]

Metta said:

> I think there is a lot of nuance to this situation, and intention is important. All industries have natural conflicts and incentives. Companies try to sell products by convincing people that their product is superior in some way, emphasizing the strengths and downplaying the weaknesses. The bar is higher, of course, in a fiduciary context.
>
> You have to talk to people, hear what they have to say about why they did certain things, read between the lines, and come to a conclusion. For me, the most important questions are: Were senior members of the firm intentionally and maliciously misleading clients? Was there a desire to not rectify the disclosure issues identified? Did it affect clients materially? The review has not unearthed any evidence that would suggest the answer to any of these questions is "yes."[47]

Ratik turned to Metta and asked, "What do you think we should do?"[48] Metta replied, "Let's get this presentation done before tomorrow. We'd better get started."[49]

What to Do?

Ratik reflected on the meeting and his conversation with Metta. He could not say with certainty that UBPB's policies had materially impacted clients. Still, he felt the firm was at fault. Ratik also felt angry and disrespected because of the way he had been spoken to during the meeting with the legal team. He thought, with some regret, that he had gone from working for billionaire investors to being bossed around by ("cowardly and pandering") junior legal executives.[50] Ratik was thinking about his next steps. Should he reach out to UBPB's compliance department? Or Uptown Bank's Board of Directors? Or should he inform regulatory authorities, such as the SEC?

Senior management was in the best position to address the issues related to guided architecture, but it seemed to him that their position was clearly in favor of maintaining the status quo. There was an anonymous compliance hotline for the division; however, it was not clear who had ultimate authority to resolve issues reported. There was also a clear risk of retaliation if it went to senior management, as only a few people had extensive knowledge of the issues raised in the review. Ratik worried that speaking up would jeopardize his position at the company and perhaps in the industry more broadly, due to Uptown Bank's influence. This was a serious risk at a time when Ratik was trying to secure a new job with a competitor.

Ratik also knew that the SEC had launched a whistleblower program as part of the Dodd-Frank Act.[51] He usually read the *New York Times* for several hours a day while at work and vaguely recalled reading an article about it. He remembered there were employment protections for whistleblowers but, upon rereading, was surprised to learn there were also financial rewards. He wondered if the SEC, which regulated securities markets, would have jurisdiction over this situation.

Inspired by the fallout of the Bernie Madoff scandal, the Dodd-Frank Act provided that the SEC would award whistleblowers whose assistance led to a sanction of at least $1 million.[52] The

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whistleblower's reward varied between 10% and 30% of any amount collected by the SEC; for example, a $1 million sanction would entitle the whistleblower to a reward of $100,000 to $300,000. (See **Appendix C** for a summary of the whistleblower program.)

The SEC reported that its whistleblower office received 3,001 tips during fiscal 2012.[53] However, the program had only issued one reward, awarded in August 2012 and amounting to $50,000. Although the ordered sanctions exceeded $1 million in the case, the SEC had only collected $150,000 from the perpetrators by that point.[54] (See **Exhibit 3** for a summary of the whistleblower fund activity in 2012.)[55] Due to the lack of awards since the 2010 legislation was passed, some observers familiar with the program believed that it was merely a fig leaf and that the SEC had no real interest in policing large corporations, the employees of which donated heavily to political campaigns.[56]

In addition, the SEC did not consider all tips to be relevant even if a firm was sanctioned; a second would-be whistleblower in the August 2012 case did not receive a reward "since the information provided did not lead to or significantly contribute to the SEC's enforcement action."[57]

Due to the nature of his role, Ratik had access to documents detailing UBPB's stance on guided architecture but was not sure if the documents alone would be enough to spur regulators to take action. Furthermore, many of the documents provided for the group's research said "Privileged and Confidential," and Ratik did not know whether he could face repercussions for copying and sharing them—or even if regulators would legally be allowed to use them as part of an investigation.

There was also no clarity as to how long it might take the SEC to investigate and issue sanctions. Based on the time it had taken to issue the first reward, Ratik theorized that it would likely take at least a year, if not multiple years, for him to receive any monetary reward; this was a concern if reporting led to losing his job. He also had no idea what a whistleblower report should entail, and he was not at all sure, given the program's history, that a substantial award was possible.

By law, the whistleblower program protected whistleblowers from employer retaliation and strove to protect their anonymity. However, only a small number of people at UBPB had access to the relevant documents, so it was likely that Ratik's colleagues would be able to identify him as a whistleblower. Ratik was also awaiting a formal job offer letter from a competing firm but did not know how long it might take or what he would do if it fell through.

If he decided to report UBPB to the SEC, Ratik assumed he would need to secure legal representation. After leaving work for the day, he anonymously reached out to a leading financial services lawyer to inquire about the possibility of representation. The lawyer said he wished he could take the case but that he was conflicted and that every major law firm would be too, as Uptown Bank was involved in a series of multi-billion dollar lawsuits stemming from the Financial Crisis.

Initially, with only a vague idea that the whistleblower program existed, Ratik had been angry he was obliged to deal with this amidst all the other chaos in his life, which included a recent divorce, an ongoing and expensive custody battle, and parents who had long since cut him off financially for his failure to settle down.

But, as he delved further, he began to wonder about what might be possible: Should he raise the issue internally, to Uptown Bank's Board of Directors, or to the SEC? Or not all? Did the SEC even have jurisdiction over this issue? Could he use the SEC whistleblower program to take down the senior executives of UBPB? Would that mean he was in line for a financial windfall? If so, what would be his primary motivation, and did it even matter? What would an effective Whistleblower submission look like? Could he use "Privileged and Confidential" information? Should he tell Metta what he was

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thinking? Did the high-net-worth clients, almost all of whom were independently wealthy, really actually suffer or even care? What were the odds that this would work? Was it worth the risk?

And what would happen if it all went wrong?

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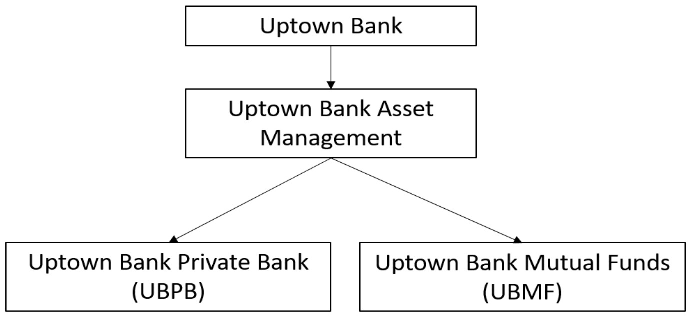
Exhibit 1 Uptown Bank Organizational Chart, 2013



Source: Casewriter.

Exhibit 2 UBPB Private Banker Performance Metrics, 2013

- Year-over-year net change in revenue.
- Year-over-year net change in clients.
- Year-over-year net change in assets.
- Adherence to regular risk review schedule.

Source: Casewriter.

Exhibit 3 SEC Investor Protection Fund Activity, Fiscal 2012

Balance of Fund at beginning of fiscal year	$452,788,044
Amounts deposited into or credited to Fund during fiscal year	$0
Amount of earnings on investments during fiscal year	$757,248
Amount paid from Fund during fiscal year to whistleblowers	($45,739)
Amount disbursed to Office of the Inspector General during fiscal year	($69,727)
Balance of Fund at end of fiscal year	$453,429,826

Source: U.S. Securities and Exchange Commission, "Annual Report on the Dodd-Frank Whistleblower Program, Fiscal Year 2012," pp. 9-10, November 2012, https://www.sec.gov/about/offices/owb/annual-report-2012.pdf, accessed October 2021.

Note: The Fund financed the Office of the Inspector General's suggestion program, which allowed employees to suggest "improvements in the work efficiency, effectiveness, and productivity, and use of resources at the [SEC], as well as allegations by [SEC] employees of waste, abuse, misconduct, or mismanagement within the [SEC]." See U.S. Securities and Exchange Commission, "Annual Report on the Dodd-Frank Whistleblower Program, Fiscal Year 2012," p. 9.

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Appendix A: Excerpt from the Investment Advisers Act of 1940

§80b–6. Prohibited transactions by investment advisers

It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction; or

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

§80b–11. Rules, regulations, and orders of [Securities and Exchange] Commission

(g) Standard of conduct

(1) In general

The Commission may promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice. In accordance with such rules, any material conflicts of interest shall be disclosed and may be consented to by the customer. Such rules shall provide that such standard of conduct shall be no less stringent than the standard applicable to investment advisers under section 80b–6(1) and (2) of this title when providing personalized investment advice about securities, except the Commission shall not ascribe a meaning to the term "customer" that would include an investor in a private fund managed by an investment adviser, where such private fund has entered into an advisory contract with such adviser. The receipt of compensation based on commission or fees shall not, in and of itself, be considered a violation of such standard applied to a broker, dealer, or investment adviser.

(2) Retail customer defined

For purposes of this subsection, the term "retail customer" means a natural person, or the legal representative of such natural person, who—

(A) receives personalized investment advice about securities from a broker, dealer, or investment adviser; and

(B) uses such advice primarily for personal, family, or household purposes.

Source: Office of the Law Revision Counsel, United States Code, Title 15—Commerce and Trade, Chapter 2D—Investment Companies and Advisers, Subchapter II—Investment Advisers, https://uscode.house.gov/view.xhtml?path=/prelim@title15/chapter2D/subchapter2&edition=prelim, accessed October 2021.

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Appendix B: U.S. Securities and Exchange Commission Regulations for Investment Advisers

VI. What Are the Requirements Applicable to a Registered Investment Adviser?

The Advisers Act does not provide a comprehensive regulatory regime for advisers, but rather imposes on them a broad fiduciary duty to act in the best interest of their clients. […] There are five types of requirements on an adviser: (i) fiduciary duties to clients; (ii) substantive prohibitions and requirements; (iii) contractual requirements; (iv) recordkeeping requirements; and (v) administrative oversight by the SEC, primarily by inspection.

A. Fiduciary Duties to Clients

Fundamental to the Act is the notion that an adviser is a fiduciary. As a fiduciary, an adviser must avoid conflicts of interest with clients and is prohibited from overreaching or taking unfair advantage of a client's trust. A fiduciary owes its clients more than mere honesty and good faith alone. A fiduciary must be sensitive to the conscious and unconscious possibility of providing less than disinterested advice, and it may be faulted even when it does not intend to injure a client and even if the client does not suffer a monetary loss. [. . .]

The duty is not specifically set forth in the Act, established by SEC rules, or a result of a contract between the adviser and the client (and thus it cannot be negotiated away). Rather, fiduciary duties are imposed on an adviser by operation of law because of the nature of the relationship between the two parties. It is [. . .] incorporated indirectly into the Act in various provisions and disclosure requirements discussed below.

Several obligations flow from an adviser's fiduciary duties.

1. *Full Disclosure of Material Facts.* Under the Act, an adviser has an affirmative obligation of utmost good faith and full and fair disclosure of all facts material to the client's engagement of the adviser to its clients, as well as a duty to avoid misleading them. Accordingly, the duty of an investment adviser to refrain from fraudulent conduct includes an obligation to disclose material facts to its clients whenever failure to do so would defraud or operate as a fraud or deceit upon any client.

   Conflicts of Interest. This disclosure of material facts is particularly pertinent whenever the adviser is faced with a conflict—or a potential conflict—of interest with a client. As a general matter, the SEC has stated that the adviser must disclose all material facts regarding the conflict so that the client can make an informed decision whether to enter into or continue an advisory relationship with the adviser, or take some action to protect himself or herself against the conflict. [. . .]

2. *Suitable Advice.* Advisers owe their clients a duty to provide only suitable investment advice. This duty generally requires an adviser to make a reasonable inquiry into the client's financial situation, investment experience and investment objectives, and to make a reasonable determination that the advice is suitable in light of the client's situation, experience and objectives.

3. *Reasonable Basis for Recommendations.* An adviser must have a reasonable, independent basis for its recommendations.

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4. *Best Execution.* Where an adviser has responsibility to direct client brokerage, it has an obligation to seek best execution of clients' securities transactions. In meeting this obligation, an adviser must seek to obtain the execution of transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances. In assessing whether this standard is met, an adviser should consider the full range and quality of a broker's services when placing brokerage, including, among other things, execution capability, commission rate, financial responsibility, responsiveness to the adviser, and the value of any research provided.

   Interpositioning. An adviser will generally not obtain best execution if it interposes a broker that does not make a market in the security when it could have avoided the unnecessary commission payments by dealing directly with market makers.

   Directed Trades. An adviser is relieved of this obligation when a client directs the adviser to use a particular broker. An adviser may, however, be required to make additional disclosure to clients when it receives some benefit from the direction of the trade.

   Use of Brokerage Affiliate. The Act does not prohibit advisers from using an affiliated broker to execute client trades. However, use of an affiliate involves a conflict of interest that must be disclosed to client. For example, use of an affiliated broker may give the adviser incentive to "churn" the account. [. . .]

Source: "Regulation of Investment Advisers by the U.S. Securities and Exchange Commission," Staff of the Investment Adviser Regulation Office, Division of Investment Management, U.S. Securities and Exchange Commission, March 2013, https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf, accessed October 2021.

Note: Footnotes from the original document have been removed to simplify the text.

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Appendix C: SEC Whistleblower Program Fact Sheet

Background

Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act authorizes the SEC to pay rewards to individuals who provide the Commission with original information that leads to successful SEC enforcement actions and certain related actions.

In passing the Dodd-Frank Act, Congress substantially expanded the agency's authority to compensate individuals who provide the SEC with information about violations of the federal securities laws. Prior to the Act, the agency's bounty program was limited to insider trading cases and the amount of an award was capped at 10 percent of the penalties collected in the action.

Rules Requirements

The final rules define a whistleblower as a person who provides information to the SEC relating to a possible violation of the securities laws that has occurred, is ongoing or is about to occur.

To be considered for an award, the final rules require that a whistleblower must:

Voluntarily provide the SEC …

- In general, a whistleblower is deemed to have provided information voluntarily if the whistleblower has provided information before the government, a self-regulatory organization or the Public Company Accounting Oversight Board asks for it directly from the whistleblower or the whistleblower's representative.

… with original information …

- Original information must be based upon the whistleblower's independent knowledge or independent analysis, not already known to the Commission and not derived exclusively from certain public sources.

… that leads to the successful enforcement by the SEC of a federal court or administrative action …

- A whistleblower's information can be deemed to have led to a successful enforcement action if:

    1. The information is sufficiently specific, credible and timely to cause the Commission to open a new examination or investigation, reopen a closed investigation, or open a new line inquiry in an existing examination or investigation.
    2. The conduct was already under investigation when the information was submitted, and the information significantly contributed to the success of the action.
    3. The whistleblower reports original information through his or her employer's internal whistleblower, legal, or compliance procedures before or at the same time it is passed along to the Commission; the employer provides the whistleblower's information (and any subsequently-discovered information) to the Commission; and the employer's report satisfies prongs (1) or (2) above.

… in which the SEC obtains monetary sanctions totaling more than $1 million.

- The rules permit aggregation of multiple Commission cases that arise out of a common nucleus of operative facts as a single action. These may include proceedings involving the same or similar parties, factual allegations, alleged violations of the federal securities laws, or transactions or occurrences.

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The final rules further define and explain these requirements.

Key Concepts

Avoiding Unintended Consequences:

Certain people generally will not be considered for whistleblower awards under the final rules.

These include:

- People who have a pre-existing legal or contractual duty to report their information to the Commission.
- Attorneys (including in-house counsel) who attempt to use information obtained from client engagements to make whistleblower claims for themselves (unless disclosure of the information is permitted under SEC rules or state bar rules).
- People who obtain the information by means or in a manner that is determined by a U.S. court to violate federal or state criminal law.
- Foreign government officials.
- Officers, directors, trustees or partners of an entity who are informed by another person (such as by an employee) of allegations of misconduct, or who learn the information in connection with the entity's processes for identifying, reporting and addressing possible violations of law (such as through the company hotline).
- Compliance and internal audit personnel.
- Public accountants working on SEC engagements, if the information relates to violations by the engagement client.

However, in certain circumstances, compliance and internal audit personnel as well as public accountants could become whistleblowers when:

- The whistleblower believes disclosure may prevent substantial injury to the financial interest or property of the entity or investors.
- The whistleblower believes that the entity is engaging in conduct that will impede an investigation.
- At least 120 days have elapsed since the whistleblower reported the information to his or her supervisor or the entity's audit committee, chief legal officer, chief compliance officer – or at least 120 days have elapsed since the whistleblower received the information, if the whistleblower received it under circumstances indicating that these people are already aware of the information.

Certain other people – such as employees of certain agencies and people who are criminally convicted in connection with the conduct – are already excluded by Dodd-Frank.

Under the final rules, the Commission also will not pay culpable whistleblowers awards that are based upon either:

- The monetary sanctions that such culpable individuals themselves pay in the resulting SEC action.
- The monetary sanctions paid by entities whose liability is based substantially on conduct that the whistleblower directed, planned or initiated.

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The purpose of this provision is to prevent wrongdoers from benefitting by, in effect, blowing the whistle on themselves.

Providing Information to the Commission and Seeking a Reward:

The rules also describe the procedures for submitting information to the SEC and for making a claim for an award after an action is brought. The claim procedures provide opportunities for whistleblowers to fairly present their claim before the Commission makes a final award determination.

Under the final rules, the SEC also will pay an award based on amounts collected in related actions brought by certain agencies that are based upon the same original information that led to a successful SEC action.

Clarifying Anti-Retaliation Protection:

Under the rules, a whistleblower who provides information to the Commission is protected from employment retaliation if the whistleblower possesses a reasonable belief that the information he or she is providing relates to a possible securities law violation that has occurred, is ongoing, or is about to occur. In addition, the rules make it unlawful for anyone to interfere with a whistleblower's efforts to communicate with the Commission, including threatening to enforce a confidentiality agreement.

Supporting Internal Compliance Programs:

The final rules do not require that employee whistleblowers report violations internally in order to qualify for an award. However, the rules strengthen incentives that had been proposed and add certain additional incentives intended to encourage employees to utilize their own company's internal compliance programs when appropriate to do so.

For instance, the rules:

- Make a whistleblower eligible for an award if the whistleblower reports internally and the company informs the SEC about the violations.
- Treat an employee as a whistleblower, under the SEC program, as of the date that employee reports the information internally—as long as the employee provides the same information to the SEC within 120 days. Through this provision, employees are able to report their information internally first while preserving their "place in line" for a possible award from the SEC.
- Provide that a whistleblower's voluntary participation in an entity's internal compliance and reporting systems is a factor that can increase the amount of an award, and that a whistleblower's interference with internal compliance and reporting is a factor that can decrease the amount of an award.

Other Recent Actions

Office of the Whistleblower:

In addition to whistleblower rules, the Dodd-Frank Act called upon the SEC to create an Office of the Whistleblower. That office, now headed by Sean McKessy, works with whistleblowers, handles their tips and complaints, and helps the Commission determine the awards for each whistleblower. The initial staffing of the office has been completed and the Investor Protection Fund, which will be used to pay awards to eligible whistleblowers, has been fully funded.

Source: U.S. Securities and Exchange Commission, "SEC Adopts Rules to Establish Whistleblower Program," May 25, 2011, https://www.sec.gov/news/press/2011/2011-116.htm, accessed October 2021.

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