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THE SPITZER EFFECT
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"Most of the mistakes and major faults of the financial era that has just drawn to a close will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that `no man can serve two masters' . . . . Those who serve nominally as trustees but consider only last the interests of those whose funds they command suggests how far we have ignored the necessary implications of the principle."

U.S. Supreme Court Justice Harlan Fiske Stone wrote those words in 1934. Today, they could have been as easily written by New York State's crusading attorney general Eliot Spitzer. At first almost alone, he turned the spotlight on the unprincipled conduct of too many financial intermediaries during the recent era.

His campaign to eliminate conflicts of interest between service providers and their clients began with Wall Street investment bankers in 2001, spread to mutual fund managers in 2003, and last month enveloped insurance brokers. While it would be unfair to tarnish the entire financial field with the brush wielded by the attorney general, the misconduct was not only rife, but practiced by some of the oldest, largest and once most respected firms in each of those fields.

The practices he attacked were open secrets to industry insiders, indeed often accepted as the normal way of doing business. On Wall Street, for example, it was hardly unusual for analysts to publish glowing "research" reports on stocks of companies that they believed were junk, often with the objective of puffing initial public offerings or winning investment-banking clients.

In the mutual fund industry, managers enriched their own coffers by aiding and abetting short-term speculators in fund shares to engage in widespread market-timing and time-zone trading, at the dollar-for-dollar expense of their long-term owners. In insurance brokerage, bid-rigging and contingent commissions — "preferred service agreements" — were used to force insurance companies to pay rebates to brokers as a quid pro quo for winning the business.

These pervasive examples of conflicts of interest in the financial services field are violations of the public trust. Trustees who accept the responsibility for other people's money have a fiduciary duty to place the client's interest ahead of their own, and those who handle money for others no less so. "Put the client first," an obvious rule for any business, takes on a whole new imperative in the profession of handling other people's money. Why? Because the value provided to clients in the financial field is measured largely in dollars and cents.

Unlike consumer products such as food, television sets, automobiles and perfume, for example, whose value is measured as much by satisfaction and style as by intrinsic worth, the value of a financial service — the performance of a brokerage account, the investment return on a mutual fund, the amount covered by a homeowner's policy, the face amount of a life insurance policy — can be precisely measured in dollars and cents. And the cost of providing that service — the advisory fees and operating expenses, the policy premiums, the sales commissions — can be precisely measured in dollars and cents as well.

The fact that product cost directly impacts product value lies at the very heart of how well financial service firms serve their clients. Costs matter. So providing real, honest-to-God, dollars-and-cents value to our clients requires offering our financial services at fair, reasonable, and competitively determined prices. If our clients are to make the best possible choices within their budgets as they seek to protect their assets and property, fully disclosed pricing is essential.

As a result of that unique relationship between cost and value, the vast multitude of American families who have placed their trust in their financial service providers must be applauding Mr. Spitzer and his staff. But since fair and open competition in our system of free-market capitalism puts pressure on prices and profits alike, many, if not most, providers of those services are excoriating these determined regulators.

Much of their criticism has been based on the attorney general's reliance on New York statutes adopted long ago, for rather different purposes. For brokers and fund managers, it was the Martin Act of 1924, a "Blue Sky" law originally designed to prosecute the "bucket shops" that were rife in the early part of the century. For insurance brokers, it was the Donnelly Act of 1893, a "Baby Sherman" antitrust act designed to block collusion and price-fixing.

Even if it has not been used for 100 years, however, a law is a law. Consider our United States Constitution, ratified 217 years ago and still standing today as a monument to our commitment to “protect the general welfare.” Mr. Spitzer’s aggressive pursuit of the public interest seems entirely appropriate under state law, and wholly consistent with that national commitment as well.

The description of the attorney general as “politically ambitious” may well be accurate. But doubtless most capable state attorneys general are “governor-ambitious,” even as most capable journalists are “Pulitzer-ambitious,” and scientists “Nobel-laureate-ambitious.” Bless them! And when we describe our businessmen and entrepreneurs as ambitious to build firms and create economic value, it’s usually meant as a compliment. Mr. Spitzer is entitled to the same treatment.

While the “Spitzer effect” focuses directly on the scandals of the era, it also points to our need to attend to the forces that have driven them. Vast changes have taken place in the structure of the financial services field. Once dominated by a series of free-standing and largely privately held professional firms, it is now dominated by giant business conglomerates whose interests span a variety of wide-ranging services which themselves often entail conflicts — commercial and investment banking; stock brokerage and mutual funds; insurance and consulting, a list that only scratches the surface.

Of course, the officers and directors of these financial titans have a fiduciary duty to serve the shareholders of their own firms. But they also have a directly conflicting duty to serve another master: the shareholders of the mutual funds they control; the holders of their insurance policies; the customers of their brokerages.

Mr. Spitzer has revealed how badly that balance has been distorted. When the chief executive of one of the nation’s largest banks announces his goal of doubling the 7% share of the bank’s revenues provided by the asset management group by “cross selling,” he sets into motion a chain of events whose outcome is almost foreordained. Managers roll up their sleeves and try to make it happen. Witness this series of e-mails at one firm: “Market timing . . . is very disruptive to the portfolio managers and operations of the fund. (However) your call from the sales side . . . I don’t want to turn away $10-$20 million . . . it’s in our best interests (increased profitability to the firm).”

In taking constructive action to restore that balance, Mr. Spitzer and his counterparts in other states have been joined by state securities regulators and the Securities and Exchange Commission. Many of the “bad apples” that have betrayed the public trust have been indicted, fined and penalized. But that’s not enough. It’s the responsibility of the “good apples” that remain to put their own character on the line, beginning with the recognition that the financial services barrel that holds all those apples — good and bad alike — is badly in need of repair.

It’s high time that our financial leaders acknowledge the mistakes and faults of the recent era and establish “best practices” that preserve, protect, and defend the interests of their customers and clients. But not only to serve them. To serve themselves. Without maintaining its character — operating with integrity, responsible conduct, and service to others before service to self — no financial service firm can achieve long-term success.

It will not be easy. As Demosthenes warned us two-and-a-half millennia ago, “Nothing is easier than self-deceit. For what each man wishes, that he also believes to be true.” Admitting mistakes requires character; so does introspection; so does changing the status quo; so does courage. But if our financial service leaders who do have character — and there are many of them — accept responsibility for what has happened, we can begin to take the necessary steps to restore the nobility of fiduciary duty to its pre-eminent place on our priority list.

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