

The Ethics of Ignorance

(March 1, 2019)

By Alvin Clay III

It was in the 80's, a time that seems like a thousand years ago now, and I was the Tax Director for a regional investment bank. A significant part of our business back then was the creation of limited partnership investments in real estate and energy. This was the peak of the tax shelter boom, where pooled investments were formed to take advantage of investor-friendly provisions of the tax code. Our real estate and oil & gas experts would find investment opportunities and "package" them in limited partnerships. Our brokers would then promote the partnership investments to our clients with, presumably, all of the proper documentation and disclosures. Not that every investment worked out as planned, but it was a good and legitimate business and would have continued to be had the Tax Reform Act of 1986 not changed all of the rules and made the investment model obsolete.

I bring this up not to begin a discussion on the ethics of tax-motivated transactions, but to recount an experience I had at the time with one of my colleagues -- an experience that came to mind as news emerged about the Bernard Madoff mess. "Bob," who worked for me in the tax department, came to me one day and said that he didn't want to be a tax guy any more. He was tired of being "behind the scenes" and wanted to be more a part of the action -- and earn the money that the sales guys made. He was going to promote tax-advantaged real estate investments to our brokers. Let's call his new job "tax shelter promoter."

I wished him well and he left my department for fame and fortune. About a month later, I was in the room when he was making a sales presentation to a group of retail branch managers. He was extolling the virtues of an investment opportunity to renovate and own an historic resort property in Florida. In the middle of rattling off glowing statistics about this particular investment, he boasted "and there are already *two thousand* room-nights booked in advance!" At that moment, one of the more knowledgeable managers in the room interrupted politely, "Excuse me Bob, but that number is *twenty thousand*, not two thousand." Bob looked at the manager with a blank expression for a few moments, then looked up to the rest of the room with a big smile on his face and said "Even better!" I stood in the back of the room and watched the members of the audience wag their heads in disgust.

It was obvious that Bob didn't know what he was talking about. Not only did he not know whether the correct number of room-nights booked in advance was two thousand or twenty thousand -- he did not know what a good number would have been. Was this resort property on target for a hugely successful opening,

or was it way behind? How did this compare to other comparable properties? He didn't know. And if he didn't know the details about this key factor, what about the rest of the information he was conveying? Could it be believed and relied upon? What were the reasonably expected risks and rewards of this investment? He had no idea. But it didn't stop him from promoting the heck out of this deal. Bob's ethical lapse was not his ignorance -- we are all ignorant about something. His indiscretion was to feign knowledge and expertise, and to attempt to persuade people to invest in a product that he did not understand. Luckily, in this case, his audience was well-informed and appropriately skeptical. Unfortunately, there are other audiences who are woefully uninformed and naïve.

This brings me to the Madoff fiasco and much else of what has been exposed on Wall Street. Now Madoff's alleged activities were not simply mistakes or violations of ethical standards. They were crimes -- outright theft. And he bears full responsibility for his actions. But there is another group of people who need to look at themselves in the mirror and ask what role they may have played in the financial ruin of so many. How many investment advisers and financial planners recommended these investments to their clients while having no knowledge of what it was that they were recommending? Certainly some conducted reasonable due diligence, relied on the expertise of others, and were defrauded along with their clients. But others did nothing of the sort. They didn't do their homework. Somewhere along the line, someone had the responsibility to actually understand what Mr. Madoff was doing to produce such stunningly consistent returns. What seems obvious in hindsight should have been obvious in advance to someone whose job it is to analyze investment opportunities and opine on them for their clients. And if they suspected no wrongdoing, but just couldn't figure out what was happening, they needed to confess as much to their clients and recommend against the investment for that reason. It's possible that they would have lost the client in the process. So be it. Sometimes integrity has a short-term price attached to it.

The same can be said about many of the so-called structured products and derivatives that were at the center of the Wall Street collapse. In many cases they were being created, packaged, re-packaged, leveraged, and promoted by people who didn't really understand them. In most cases, the investment professionals weren't trying to cheat anyone. But they put investors at risk by their ignorance, and contributed to the misery of an unsuspecting population.

Those who get paid to give advice to others, and those who design and promote investment products have a moral obligation to know what they are doing. A simple "buyer beware" warning is not enough. We're not talking about selling someone a cup of coffee that may be too hot. There are life savings, retirements, and college educations at risk. Our clients put their futures and that of their families in our hands. We owe them more than a glib sales pitch and a mind-numbing disclosure document.

So brokers, advisers, accountants, planners, bankers, and anyone else who is apt to give investment advice, here is some advice for you It's OK to not

understand an investment. But if you don't, don't recommend it to a client. We have all learned a painful lesson -- the price of ignorance can be very high.