

Teaching Notes

THE INVESTMENT BANK JOB

The U.S. Securities and Exchange Commission
v. Goldman Sachs

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On April 16, 2010, the Securities and Exchange Commission (SEC) charged Goldman Sachs and Vice President Fabrice Tourre with defrauding investment client ACA Management LLC (ACA) through the preparation and marketing of a financial product linked to subprime, or second-rate, mortgages. This financial instrument, entitled Abacus 2007-AC1 (Abacus), had been created specifically for an institutional client, John Paulson, the manager of the hedge fund Paulson & Company. When Goldman traders met with ACA they presented an array of possible mortgage investments from which ACA could select. As was made apparent in the subsequent S.E.C investigation, however, during its interactions with ACA, Goldman deliberately misled the company to believe that Paulson & Company was also investing in Abacus. In actuality, Paulson & Company was making the opposite investment wager, with the expectation that Abacus would lose money. Paulson's firm, with Goldman's assistance, was betting that the housing market would collapse.

Coming on the heels of the financial crisis, this behavior epitomized to many the erosion of integrity within the financial industry that had occurred following the regulatory reforms in the 1980s and late 1990s. Observers point to a number of changes over those decades that contributed to a fundamental, and negative, shift in internal practices and organizational culture. These changes include a shift from the partnership model toward the publicly traded bank and a loosening of governmental regulatory reins. This case study examines the evolution of the modern financial industry and the organizational and structural shifts within Wall Street banks that led to the case against Goldman Sachs.

The case and teaching notes for The Investment Bank Job: The U.S. Securities and Exchange Commission v. Goldman Sachs, by Andrew Schrieber, was completed under the direction of Dr. Rebecca Dunning, The Kenan Institute for Ethics.

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Teaching Notes

Target Audience

Organizational Studies
Organizational Behavior
Ethics
Finance

Learning Objectives

1. To garner an understanding of the shifting face of modern finance and what the ethical implications of this shift entails.
2. To consider how the organizational and structural components of both individual firms, and the financial industry holistically, factor into organizational crises.
3. To employ various perspectives in ethics to more critically analyze the crisis at Goldman Sachs.
4. To develop an understanding of some of the abstract concepts and historical developments in finance.

Questions for class discussion

1. Topic: Organizational Evolution and Crisis

Consider how traditional banks evolved from conservative partnership models with each partner's cumulative wealth on the line with each transaction toward the publicly traded financial behemoths that are financially dependent on their investing shareholders.

How does the shift from personal responsibility over one's collective stake in the pool of partnership funds to responsibility solely to the firm's shareholders change organizational behavior? What does this entail for the organizational culture of a firm such as Goldman Sachs?

Potential Answer:

Under the partnership model, bankers were cognizant of their partners' financial transactions and investment wagers at all times. There was a sense of collective responsibility that guided individual decision-making, largely because of the oversight of other partners and the direct stake that each individual banker held in the success or failure of the firm.¹

This was lost when banks became publicly traded entities. The prioritization of the firm's shareholders above the firm's internal commitment to collective stability through individual responsibility which, to some degree, even superseded the interest of the firm's clients, is all indicative of some of the changes brought about by the loss of the partnership model. Considering how shareholders' chief concern resides in being on the receiving end of increasingly larger quarterly returns to justify their investments, firms like Goldman Sachs became increasingly oriented toward and focused upon their bottom line. This came at the expense of pursuing more traditionally conservative investments in favor of riskier wagers, as well as serving as further justification for engaging in activities that

¹ A broader discussion of the practical and theoretical underpinnings of the dichotomy that exists between the partnership model and the publicly traded firm can be found in the following journal article: Morrison, Alan D., and William J. Wilhelm, Jr. "Partnership Firms, Reputation, and Human Capital." *The American Economic Review*. 94.5 (December 2004). 1682-1692.

pushed the boundaries of financial legality.² This is indicative of the defined shift in the distribution of risk from the executives of the publicly traded company to the mass of investors who remain largely faceless to those working at Goldman.

On the other hand, there were many legitimate justifications for taking the bank public that stem from the heightened access to the financial markets that derives from being listed on a stock exchange. For starters, opening the bank up to investing shareholders provides an immediate capital infusion that could expand business and augment the firm's operations. Additionally, as a publicly traded firm, the bank would have permanent access to a reserve of investor capital. Another notable benefit is that a publicly traded company could assign a market value to an individual's holding in the company that is indicative of the success, or lack thereof, of the firm. Particularly in terms of compensation, this allows for individual employees to have a collective stake in ensuring and promoting the success of the firm. While this might dissuade individual short-sightedness for purely selfish gains, as noted above, the opposite effect could occur when short-term decisions are made on a quarter-by-quarter basis to boost the firm's bottom line.^{3,4} Proponents of deregulation also contend that freer markets, unrestricted by regulatory measures, allow for broader socioeconomic benefits. This line of thinking maintains that in a completely open market investors and innovators are able to connect more easily. Thus, these connections bring in more capital that stimulates the private firm and creates positive externalities for society as the public is indirectly enriched.

2. Topic: Regulatory Devolution and Crisis

Consider the economic and political environment in terms of regulatory policy during the decades leading up to the crisis at Goldman Sachs.

How do the different historical narratives and ethos of the decades immediately following the Great Depression and of the 1980s and 90s help to explain the crisis at Goldman Sachs? How did the two varying historical mentalities affect organizational behavior in the realm of finance?

Potential Answer:

In the aftermath of the Great Depression, the federal government sought to combat the institutional ills inherent within the financial system. Sweeping legislation set up regulatory agencies such as the Securities and Exchange Commission, and specific financial products were placed under direct federal oversight for the first time.^{5,6} Shell-shocked from the virtual collapse of the American economy, bankers following the Great Depression were generally risk averse and aware that every tremor a banker initiated within the financial system could add enough undue strain to bring the structure down.⁷

In contrast, the Reagan Revolution of the 1980s championed neoliberal policies and a deregulatory zeal meant to embolden individual economic agents. This spilled over into the 1990's under President Clinton, and culminated in 1999 with the repeal of Glass-Steagall, a Depression-era law separating commercial and investment banking units,

2 Further discussion of the drawbacks associated with publicly traded financial institutions can be found in the following readings: Gross, Daniel. "The Gang of Five, and How They Nearly Ruined Us." *Slate*. 29 Jan 2010: 1, as well as Davidoff, Steven M. "Did Going Public Spoil the Banks?." *The New York Times*. 22 Aug 2008, Global Edition Business Day: 1.

3 Endlich, 258. In addition, the second section of Chapter VII beginning on page 267, details the internal arguments that senior level executives at Goldman Sachs had concerning the decision on whether or not to take the firm public.

4 Damodaran, Aswarth. "Investment Fables: Tall Tales about Stocks." NYU Stern School of Business (2005): <http://pages.stern.nyu.edu/~adamodar/New_Home_Page/invfables/ipo.htm

5 Landis, James M. "The Legislative History of the Securities Act of 1933." *George Washington Law Review*. 28.29 (1959): 29.

6 Tracy, John E., and Alfred Brunson MacChesney. "The Securities Exchange Act of 1934." *Michigan Law Review*. 32.8 (June 1934): 1025.

7 This risk-averse sentiment after the Great Depression was captured both formulaically and sentimentally in the following work: Cogley, Timothy, and Thomas J. Sargent. "The Market Price of Risk and the Equity Premium: A Legacy of the Great Depression?." *The Journal of Monetary Economics*. 55.3 (April 2008): 2-4.

as well as the Commodities Futures Modernization Act of 2000, which exempted all financial derivatives from regulation.⁸ During these two decades, and carrying over into the 2000s, bankers were essentially told by public policy makers that there were no rules, or at the very least, increasingly fewer of them to worry about. The top financial brass, including Federal Reserve Chairman Alan Greenspan, fervently believed in the self-correcting nature of the open marketplace. In this conceptualization of the financial realm, even wholly unregulated financial products would be priced and tightly controlled according to the parameters of market demand.

This translated into a winner-take-all, risk-seeking mentality that touted the individual above the institution and ultimately brought the financial system to the brink of collapse in the fall of 2008. In terms of Goldman's crisis, the government had effectively turned a blind eye to the type of financial product that the investment bankers in the mortgage division had concocted for John Paulson. With no oversight from governance structures, Goldman was able to create their own speculative game. Since there were virtually no rules guiding the construction of their financial product, Goldman was predisposed to a lawless mentality that ultimately led them to disregard basic legal standards concerning fraud.

3. Place yourself in the position of hedge fund manager John Paulson from this case study.

Mr. Paulson was not charged or even accused of any wrongdoing by the Securities and Exchange Commission for the crisis analyzed in this case study. Imagine that as Mr. Paulson you were intimately aware of the deceptive behavior in which Tourre was engaging. Yet, you recognized the multi-billion dollar payoff you would receive for a successful wager, and you understood all participating parties to be sophisticated consenting investors to whom Goldman owed no fiduciary duty. If you became aware that Tourre had engaged in illegal fraudulent behavior, would you have intervened? If so, would you have informed ACA Management of the true nature of your investment wager? Or would you have gone through Tourre instead, reprimanding him for his actions?

4. Topic: Adversarial Ethics and Asymmetrical Information

Scholar Joseph Heath constructed a theoretical framework for evaluating adversarial ethics in the realm of economics and business.⁹ Adversarial ethics can be conceptualized as the principles of engagement underlying relations or organizations that are designed to be inherently competitive or antagonistic. Consider the following vignette:

“[I]n 1994, shortly after the privatization of agriculture and food production in Hungary, the country was swept by an epidemic of lead poisoning. After searching far and wide for the cause, doctors and scientists finally tracked down the source of the problem. Manufacturers of paprika – a staple of Hungarian cuisine – had been grinding up old paint, much of it lead-based, and adding it to the spice in order to improve its color. The practice was so widespread that officials in Hungary were forced to order all the paprika in the country removed from store shelves and destroyed. This is a clear example of firms using an impermissible strategy – exploiting an information asymmetry – in order to compete, and other firms being forced to do the same, in order to retain position.”

In what ways does this example of adversarial ethics in a business setting, steeped in capitalizing on an informational asymmetry, relate to the crisis at Goldman Sachs? Are the financial implications of the fallout from the crisis

⁸ For further scholarly discussion about the repeal of Glass-Steagall, as well as information about the organizational attributes of the financial industry prior to the repeal legislation, the following is highly informative: Barth, James R., R. Dan Brumbaugh Jr., and James A. Wilcox. “Policy Watch: The Repeal of Glass-Steagall and the Advent of Broad Banking.” *The Journal of Economic Perspectives*. 14.2. (Spring 2000). 191-204.

⁹ Heath, Joseph. “An Adversarial Ethic for Business: or When Sun-Tzu Met the Stakeholder.” *The Journal of Business Ethics*. (Springer 2006): 7.

analogous to the business detriments that the above example brought on? Is the framework of adversarial ethics appropriate to analyze the Goldman Sachs crisis?

5. Topic: Organizational Ethics and Internal Practices

Goldman Sachs has fourteen business principles that act as the company's ethical framework to guide internal conduct.¹⁰

It can be argued that throughout the four-month stretch when Goldman Sachs was arranging the financial product for Paulson & Company, Goldman did not violate any of their fourteen principles in conducting their business. For instance, the first principle details how, "Our clients' interests always come first." Mr. Tourre could argue that he was prioritizing Mr. Paulson's interest in Abacus. Likewise, the last of the principles states that, "Integrity and honesty are at the heart of our business." During the assemblage of the financial product, Mr. Tourre never explicitly lied to ACA Management about Paulson's role, he simply did not inform the firm of the true nature of his involvement.

Yet, the Securities and Exchange Commission still charged Goldman Sachs with fraud, and the firm ultimately paid out \$550 million to settle the lawsuit out of court. However, in a statement accompanying the firm's settlement, Goldman Sachs did not admit to any wrongdoing, only that the marketing materials were not sufficiently informative.

How then can these conflicting interpretations of Goldman's guilt be reconciled? Particularly, in light of the mixed interpretation of whether or not Goldman adhered to their business principles, what does this entail for the firm's culpability? Specific to the legal settlement in the crisis, did Goldman Sachs admit to a lie by omission? If so, how does that fit into the fourteen principles that the firm established? Is it ethically reprehensible to omit critical details even while being largely open and upfront about a matter?

Potential responses:

This is a particularly contentious set of questions because of the polarized set of responses from those within Wall Street and those outside of the financial industry. Indeed, even the S.E.C. decision to sue Goldman Sachs was split along party lines, with three Democrats voting in favor of the lawsuit and two Republicans voting against it.¹¹ Indeed, throughout the entire S.E.C. ordeal, Goldman Sachs vehemently denied that they engaged in any illegal activity in any form.

Goldman Sachs and Vice President Fabrice Tourre may have followed financial regulations yet in their strictly literal interpretation of the rules the financial firm arguably failed to adhere to basic social values of honesty and responsibility. Regulations may inadvertently provide a justification for such behavior; a financial institution only has a legal obligation of fiduciary duty if it is acting in an advisory capacity.¹² As they would claim in the S.E.C. investigation, Goldman Sachs was specifically acting as a broker-dealer, or market maker, for the collateralized debt obligation. Their function was simply to be a neutral intermediary agent, matching up various counterparties to invest or bet against the financial product.¹³

10 Goldman Sachs' business principles can be found in Appendix C or online at: <http://www2.goldmansachs.com/our-firm/our-people/business-principles.html>

11 Westbrook, Jesse. "Goldman Sachs CDO Lawsuit Split SEC Commissioners in 3-2 Vote." *Bloomberg Businessweek*. 04 Apr 2010: <<http://www.businessweek.com/news/2010-04-20/goldman-sachs-cdo-lawsuit-split-sec-commissioners-in-3-2-vote.html>>.

12 The Securities and Exchange Commission provides a detailed legislative breakdown of the Investment Advisers Act of 1940 in Release No. 1889 posted on their website on August 3, 2000. The release can be found at: <http://www.sec.gov/litigation/admin/ia-1889.htm>

13 Klapper, Richard H., Michael T. Tomaino, Jr., and Christopher J. Dunne. United States of America before the Securities and Exchange Commission. *In the Matter of ABACUS CDO File No. HO-10911*. New York City: Attorneys for Goldman, Sachs & Co., 2009. 38.

In any case, fraud is never permitted under any reading of the financial regulatory code. Goldman Sachs went further than positing a lie by omission and is on the record as having conducted meetings, drafted published material, and misdirected email and phone conversations to misrepresent Paulson & Company's contrarian position to ACA Management's own investment interests. This behavior contradicts Goldman's own 14th principle of conducting themselves honestly and with integrity. In an industry where image and trust are everything, a violation of such elementary principles, legal or not, is ultimately in no party's interest.