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Goldman Sachs and the Threat to Capitalism

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“Oh, I have lost my reputation! I have lost the immortal part of myself...”
—Cassio’s lament.

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Blankfein is "trying to lead this firm at a time when God couldn't lead it without being criticized."

—New York City Mayor Michael Bloomberg

Somehow, Goldman Sachs continues to be involved with God. When CEO Lloyd Blankfein admitted overstating his importance when he claimed he is "doing God's work," that should have been the end of attempts to effect a merger between God and mammon. It wasn't. After Gregg Smith, an employee with twelve years of service, resigned from the firm with a flourish—a letter published by the *New York Times* denouncing Goldman's ethics and business practices—both the Mayor of New York and the CEO of Morgan Stanley leapt to Goldman's defense, replete with references to God.

Mayor Mike Bloomberg hied down to the firm's headquarters to show his support for the investment bank, "a great firm" in the Mayor's view. In 1966 Goldman won Bloomberg's enduring affection by offering him his first job after he graduated from Harvard Business School—at the then-handsome salary of $14,000 per year, equivalent to $100,000 in today's money, which is probably somewhat below what is now offered to the best and brightest. Goldman nurtured that initial affection by becoming one of the larger users of the services of Bloomberg's eponymous firm and, as the Mayor pointed out, by pouring into the City's treasury the millions in the taxes levied on Goldman and its thousands of New York City-based employees. Their involuntary contribution to the City's coffers represents a significant enough sum to have induced His Honor to lavish millions in subsidies on Goldman Sachs to persuade it to locate its new $2.4 billion building in downtown Manhattan, rather than go through with its (to this writer, incredible) threat to move to, get this, New Jersey, a move many Goldman bankers viewed with horror.

Back to God. Blankfein, said Bloomberg, is "trying to lead this firm at a time when God couldn't lead it without being criticized". The billionaire mayor does travel in the very highest circles, but he provided no source for a statement that, if it means anything, means that if the Lord took time off his other duties to run the investment bank, He would lead it exactly as Blankfein has, and nevertheless be severely criticized.

"There but for the grace of God go us."

—James Gorman CEO, Morgan Stanley

Adding to the God storyline is James Gorman, CEO of Morgan Stanley. "There but for the grace of God go us," Mr. Gorman told a breakfast meeting hosted by Fortune magazine. Presumably, Morgan Stanley would not need God's grace to avoid criticism if it practiced investment banking differently from Goldman, but because Mr. Gorman's statement implies that his bank's practices are broadly in line with those of Goldman Sachs, it indeed might well thank God for the fact that Goldman is a lightning rod for criticism that might otherwise be directed at the entire industry, Morgan Stanley included.

Enough of the numinous. On to the secular. Goldman's recent troubles did not begin with the letter to the *New York Times*. That op-ed piece could be—and was—dismissed as the whine of an employee—one of 30,000 Mr. Blankfein pointed out in an internal memorandum—unhappy with the failure of the firm to promote him, published by a pro-Obama newspaper eager to lend support to the business- and rich-bashing that seems to be an important plank in the President's re-election platform. After all, as Goldman's CEO pointed out, a People Survey to which 85% of the firm's employees responded showed that 89% of respondents believe that the firm provides "exceptional ser-

vice" to its clients. Besides, Mr. Smith made sure to cash his latest bonus check before publishing his resignation letter, so what kind of man is he anyhow? A Woody Allen disciple who takes the money and runs?

Which misses the point entirely. If this angry, sad letter were the only recent attack made on Goldman's business practices, even the *New York Times* could not convert it into a broad attack on the firm and its ethical standards. But Goldman is the firm that urged its clients to buy dicey mortgage-backed securities that it was simultaneously unloading from its own portfolio—paying a $550 million fine to the SEC to settle the case and end the stream of adverse publicity. And it is the firm that ended up on both sides of a recent merger transaction, collecting fees from both buyer and seller, and allowing one of its senior bankers to hold a significant personal stake in the party he was advising without disclosing that he stood to profit if his advice were followed—which it was. After reviewing the entire transaction, including the failure of the seller's CEO to reveal that he just might prefer something less than the highest price because he was interested in buying the firm himself, Delaware Chancery Judge Leo Strine concluded, "This kind of furtive behavior engenders legitimate concern and distrust." Judge Strine also found the failure of the Goldman partner to mention his personal stake in the outcome of the deal "a very troubling failure that tends to undercut the credibility of … the strategic advice he gave."

If legality is to become the only test that the business practices of the leaders of our capitalist system must pass, we are indeed in trouble.

In the end, the court leaves it to the shareholders to decide whether to approve the deal. But there is little in his opinion that can make Goldman comfortable, or lend any support for the way the firm—and many of its colleagues in

the financial services sector—practice their version of market capitalism.

If this were a mere matter of money, it would matter very little, except to the players involved. Alas, there is more to it than that, much more. American capitalism is under siege, and not only because of the recent recession, the alleged inability of the middle class to hold its own while "the rich" claim a larger and larger slice of the national pie, and the apparent success of the Chinese model of state capitalism. It is under siege in part because the misfeasances of bankers only recently saved from bankruptcy by tax-payer bailouts have undermined American capitalism's claim to moral superiority—a claim based on the system's ability to produce rewards commensurate with performance, and to distribute its benefits in a manner seen as fair, something difficult to define but something most people know when they see it. All within the context of a political system that maximizes individual freedom.

Goldman is confronted by a vote-hungry President looking for whipping boys against whom to direct his populist re-election campaign.

The reasons for this loss of approbation are made clear by the obtuse responses of several leaders of the business community to criticisms of some of the business methods of Goldman Sachs. The first response is irrelevant even if true: "The firm did nothing illegal". If legality is to become the only test that the business practices of the leaders of our capitalist system must pass, we are indeed in trouble. At minimum, that leads to a race between politicians eager to pass laws and impose new regulations, and businessmen seeking to skirt those laws. There might be nothing illegal for a board of directors composed of a CEO's cronies to hand him a golden goodbye after he has seriously damaged the company's fortunes, but it is the sort of thing that pro-

duces the reaction, "There ought'a be a law." And laws we get, laws as likely to ensnare the innocent in burdensome paper work as to affect the actions of the morally challenged.

"Buyers of mortgage securities were not little old ladies."

—Michael Bloomberg

The second defense is: "It was ever thus." Nothing new in what Goldman and others have done—look back, as the *Washington Post* recently did, to the firm's behavior when its clients had to sue to recover money lost when Goldman failed to advise them of "material adverse information" to which it was privy during the run-up to the Penn Central bankruptcy in 1969, selling them commercial paper at 100-cents on the dollar when it knew the railroad was running out of cash.

The "ever thus" defense rests on dredging up of past sins to be effective; it is as if Willie Sutton pleaded not guilty to his latest bank robbery on the ground that, after all, he had heisted banks many times before. This defense might have worked in the days before investment banks became dependent on the taxpayer (aka voter) for their survival, before Goldman received some $10 billion in bailouts and emergency lending, and before the days of multi-million dollar bonuses and conspicuous consumption. It is unlikely to prove effective now, especially with a vote-hungry President looking for whipping boys against whom to direct his populist campaign (while at the same time inviting Mr. Blankfein to join him in the White House at a state dinner for British Prime Minister David Cameron, a thank-you for the financial support of Goldman partners in the last election, and a gamble that he can woo the firm away from its current candidate-du-jour, Mitt Romney.)

Those in the financial community who rely on the "it was ever thus" defense seem not to have grasped what *Financial Times* columnist Philip Stephens so succinctly summarized: "Standards that passed muster during the boom years have now begun to look like a serious source of reputational risk. . . . Faced with austerity for as far ahead as the eye can see, voters have lost patience with cheating and excess. . . . Custom and practice is no longer sufficient defence."

Goldman continues to attract the best and brightest, and ranks number one in deals and stock issues.

The third defense is more subtle: "The market is telling us that Goldman, which racked up $4.4 billion in profits last year, is performing a service its customers find more than satisfactory." These customers, Mayor Bloomberg points out, can take care of themselves: "Buyers of mortgage securities were not little old ladies," he offered as part of his defense of the firm, a way of saying that the emptors know how to caveat. Perhaps these not-little-old-ladies should have had reason to suspect that Goldman was selling what it was urging them to buy, but they also had reason to believe that even Goldman, known for its devotion to its own interests, would not dare be on both sides of such a huge trade without revealing its interests.

Still, Goldman survives and prospers. Last year it ranked number one in worldwide announced mergers and acquisitions, in equity and equity-related offerings, and in initial public offerings (IPOs). Its clients value its competence more than they fear what one asset manager calls its "self-serving," producing what Greg Hayes, chief financial officer of United Technologies, described to the *Financial Times* as "a love-hate relationship with Goldman…" Holman W. Jenkins, Jr. writing in the *Wall Street Journal*, com-

bines the little-old-ladies and conflicts-less-important-than-competence defenses: “The sophisticated parties that Goldman Sachs deals with are untroubled by the conflicts of interest that so excite observers from afar.” So it would seem from Goldman’s continued, although diminishing, commercial success.

The fourth defense was mounted by Christopher Flowers, a Goldman alumnus (nineteen years with the firm), now head of the successful private equity firm, J.C. Flowers. Flowers feels that Goldman manages its conflicts efficiently, “but ultimately Goldmans’ primary responsibility is to its owners.” Tom Braithwaite, the *Financial Times*’ estimable columnist, put it slightly differently, “If Mr. Blankfein does want to stay [as Goldman CEO], he should worry less about the criticism or Mr. Smith and more about making money.” Two problems.

First, the “primary responsibility” of Goldman’s managers to its owners is not to maximize profits deal-by-deal, quarter-by-quarter, or even year-by-year, but to have what the great and formidable former senior managing partner, the late Gus Levy, called “long-term greed”, which financial writer William Cohan says “meant treating your clients right.” Second, we live in fraught times. In addition to its responsibility to its shareholders, Goldman has a responsibility not to behave in a way that makes it more difficult to defend the capitalist system on which not only its own survival ultimately depends, but on which we rely for an efficient allocation of capital and a defensible distribution of the income and wealth generated by the system. As a beneficiary of a government bailout, it is ill-placed to defend the proposition that profits are merely the reward for its shrewd

Leaders of the financial community must understand that it is crucial to preserve broad public support for market capitalism.

risk-taking and for its ability to win in the fiercely competitive game of finance capitalism. It may well be that nothing it has done has had or will have reputational consequences that affect the bottom line or its ability to recruit top students from top schools (the flow of applications has been unaffected by recent headlines). But those actions carry externalities—costs borne by market capitalism as a system, even if not by Goldman itself. The firm's actions beget costly regulations that burden all financial institutions, and create reputational damage for the capitalist system at a time when its existence in anything like the form that has produced the greatest material well-being the world has ever seen is under threat.

Most damaging of all to those who would defend capitalism, and in this case those at the center of the financial system that is supposed to allocate capital to its highest and best uses, is Goldman's feeble attempt to navigate this sea of troubles. It is, in the words of the *Wall Street Journal*, "considering strengthening its internal rules on disclosure to clients of bankers' financial holding." Think of it. A committee of senior Goldman bankers, until now untroubled by a firm culture that allowed one of its bankers to fail to reveal a potential conflict of interest of the sort that troubled Judge Strine, will now convene to consider whether the firm's rules need changing. Certainly not because there is anything intrinsically wrong with the rules and culture as they now exist, and have been at least tacitly and perhaps thoughtlessly gone unchallenged by the current management. So it must be because the great unwashed are getting restless, or can't tell a Goldman customer from a little old lady, or because politicians are taking to populist attacks in this election year,

or because hypercritical judges just don't understand that a banker holding shares in a company he is advising on a merger has no need to reveal a potential conflict of interest.

No doubt there will be changes, and potential conflicts made transparent, leaving it to the client to decide whether to retain the firm or a particular banker within it. As one hedge-fund manager told *The Wall Street Journal*, "The benefits of trading with Goldman outweigh the costs. End of story." That might be true for that and perhaps other Goldman clients. But the private cost:benefit calculation does not include either the benefits Goldman creates by adding to the depth and quality of capital markets, or the costs it imposes on society by eroding the reputational capital of free-market capitalism. Added transparency would undoubtedly represent progress, but only to the extent of helping individual clients to decide whether the risks of dealing with Goldman are offset by its enormous competence. Better still would be a search for the moral compass that once guided at least many leaders of the financial community, and an understanding by the leaders of that community of their responsibility to preserve broad public support for market capitalism. A man of "rank and fortune," wrote Adam Smith, is "obliged to a very strict observation of that species of morals," expected by society of such men if they are to retain their "authority and respect. . . . He dare not do anything which would disgrace or discredit him."

It is all there in their dog-eared copies of *The Wealth of Nations*.

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