***Goldman v. United States*: What it Really Means**

By John Fullerton, former Managing Director of JPMorgan and *Founder* of the Capital Institute.
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"It is not what a lawyer tells me I may do, but what humanity, reason and justice tell me I ought to do."

- Edmund Burke, statesman, philosopher

With this quote, I closed my December 31, 2009 year-end letter to Lloyd Blankfein, the third private letter I sent him during 2009. In light of their relevance to current events, I have decided to make the letters public now, including Mr. Blankfein's response to the first letter, which provides the context for the "Goldman Sachs Historic Speech" dated May 30, 2009 that accompanied my second letter.

I don't know if Goldman committed fraud; that's for a judge and jury to decide. I'm sure they believe the case is without merit: the "two consenting adults" defense. I suspect it will be a tough case for the SEC to win, regardless of the principles at stake. However, to focus on the legal technicalities of the case is to miss the point.

What Goldman doesn't appear to get is why this issue is proving to be the tipping point that will force a fundamental rethinking of the purpose of finance in society that will last long beyond the current rush for financial reform. Goldman is on the wrong side of history on this matter. At its core, Wall Street's failure is a failure of leadership; no laws or regulation can ever make up for the absence of principled and courageous leadership. We lack financial statesmen like John Whitehead, former Co-Chairman of Goldman Sachs and Deputy Secretary of State in the Reagan Administration, and Sir Dennis Weatherstone, Chairman and CEO of JPMorgan from 1990 to 1994. I know John, and I am sure he is distraught at the thought of *Goldman v. United States* and all that it represents. I knew Dennis, and I know he would be turning in his grave if he knew about Jefferson County, Alabama, much less how recklessness and derivatives conspired to destroy trust in the financial system.

Goldman v. United States must be understood not just on its legal technicalities, but as a crisis in leadership and governance on Wall Street in general and at Goldman Sachs in particular. I will address both:

Wall Street

Four fundamental issues lie at the heart of society's disgust with Wall Street:

1. Greed. As a civilized society, we reject extreme greed, notwithstanding Michael Douglas' temptation that "greed is good". Unbridled speculation no matter the costs suggests a motivation of pure greed. Philosophers and religions going back to Aristotle

have taught us to reject greed. Interestingly, modern society has no equivalent word for the ancient Greek term "chrematistics". It means the acquisition of wealth as an end in itself, particularly through the use of money to make money. Aristotle understood finance as a means to an end, not an end in itself. The end was "oikonomike", the root of our word "economics", which did not suggest unlimited wealth, but rather the wealth necessary to live, and to live a good life. In contrast, chrematistics suggests there is no limit to wealth and property accumulation. Aristotle calls it "justly censured" (*Politics* I) because it is "unnatural"; it looks to acquire money without limit, while money ought to be looked for within limits, and for a higher purpose (to live a good life).

Wall Street is increasingly viewed today as a rigged casino, in which the purpose is chrematistics. While such a definition is inaccurate and unfair, we must acknowledge the truth that exists. The acts of some (I will not say just a few) tarnish the reputation of the whole. All of Wall Street suffers.

2. Injustice. Society understands that Wall Street has failed to deliver on its public purpose: to channel savings into productive investment, to provide credit for legitimate consumer and business needs, and to maintain a financial system built on trust. Wall Street has elevated self-interest above all three of these functions, in a frenzy of competitive lust for profits. Worse, when the failures that resulted from sheer stupidity and apparent outright fraud (historians will ponder how "liars' loans" became a technical term) were made manifest, too few paid the consequences. Instead, society will bear the extraordinary burden for generations to come. Real pain has been inflicted on billions (with a "b") of people, lives have been ruined, and suicide has left behind broken families. The bad guys and idiots got away; and they took the money! Many continue to do so. This is a profound injustice. Historically, such injustice breeds social unrest. Wall Street does not appear to get this, or care.

3. Conflicts of Interest. Conflicts of interest abound on Wall Street. Their tolerance violates society's innate demand for integrity and fairness. It has been acceptable practice for firms to declare their pride in "managing" such conflicts, with elaborate and documented procedures including "Conflicts Committees". Goldman Sachs even states that it "embraces" conflicts as a central feature of its business model. Managing conflicts worked reasonably well in the gentler times that pre-dated deregulation and globalization. But if we have learned anything from this financial crisis, it is that allowing modern Wall Street to "manage" its conflicts on its own in the highly competitive environment in which it operates is a recipe for disaster, both for the individual firms, and for the system as a whole. At the heart of Wall Street's excess profits has been its ability to exploit blatant conflicts of interest and the related information and power asymmetries. Eliminating such conflicts from the financial system will significantly reduce the profitability of certain activities and therefore be resisted fiercely by the industry. Some stock prices will suffer, at least in the short run. But elimination of these conflicts is the only way to restore the trust upon which the health of the system depends.

4. Hubris. Wall Street attracts many smart people. Some are wise and possess good judgment, some are clever deal-makers, some are good traders, some are brilliant mathematicians. Many are mediocre, like the rest of us, but often good people. But for those at the top, success (and money) often breeds arrogance.

> Misplaced arrogance is the worst of all, and dangerous to society when it presides over financial firms that are too complex, and too big to fail, manage, or govern. Many who rose to the top of Wall Street firms were not qualified to run the organizations they found themselves responsible for; this much is self-evident. Understanding how this happened, and continues today is critical if we are to avoid the same mistakes in the future. Wall Street was and remains dangerously arrogant at the top. Society knows this, and is rightfully outraged.

Goldman Sachs

I competed against Goldman Sachs for almost 20 years during my time at JPMorgan. I've been on the receiving end of their pitch as a director of private companies. They are the best in the business. Goldman is the epitome of Wall Street, for better and worse. "Goldman envy" is real, reflecting not only Goldman's prowess, but also a sickness resting deep within Wall Street's culture. We know envy is unhealthy, and the envy driving so much behavior on Wall Street for more, more, more is at the heart of society's ills.

Goldman faced a critical turning point in early 2009, and they sensed it. Lloyd Blankfein made gestures toward seizing the high road, as reflected in his February 8, 2009 Op-ed in the Financial Times which was the catalyst of my first letter to him. In that letter I wrote,

We are in extraordinary times, which call for unprecedented statesmanship from our financial leaders. As a trader by training, you grasp our predicament better than many leaders on Wall Street. But as a trader, you've not had the responsibility of global financial statesman. Until now.

However, Blankfein's gestures now appear self-serving and gratuitous, rather than motivated by the genuine leadership so desperately needed at the time. As a friend who runs a major division of a "too big to fail" bank said to me at the time, "there is a complete vacuum of leadership in our industry". The subsequent "God's work" quip only highlighted the point.

I pleaded for Blankfein to muster the courage to assume the role of financial statesman that only he could fill given Goldman's stature in the industry. Unfortunately for us all, it was not to be. Goldman's board must share in this failure; the entire franchise is now at risk as a result.

The SEC's aggressive action must be understood in this context. The brush is dry; the gasoline is everywhere. *Goldman v. United States* is simply the match. It is an isolated case that serves as a metaphor for all that ails Wall Street and Goldman Sachs in particular. It is therefore not that important how the lawyers ultimately settle the score. Resolution can only come through addressing the four core issues outlined above, and through real financial reform that is beyond the scope of any legislation pending in Congress today.

I will now address each of the four issues in the context of Goldman Sachs specifically, but a similar analysis could be done for all of the mega banks and for Wall Street in general.

<u>Greed</u>: Others have pointed out the difference between the "long term greedy" culture of Gus Levy and John Whitehead that always put clients' interests first, and the unbridled greed, win at all costs character of the modern Goldman culture. Restoring culture is really hard. Time will tell if Goldman is up to it – I would bet they'll succeed. Certainly a new management team and a

transformation of Goldman's business model along the lines outlined in my "Goldman Sachs Historic Speech" are pre-requisites. Is the Board of Directors up to the task? How long will it take? We will see.

Injustice: In my letters to Mr. Blankfein, I outlined my thoughts on the injustice of Goldman Sachs' senior management personally benefiting from the taxpayer rescue of the financial system (Goldman was next in line to crash after Morgan Stanley in my view), drawing a contrast with the predicament of Dick Fuld in particular. I named their personal holdings of GS stock "illegitimate wealth", and made suggestions regarding appropriate actions that are fitting with the scale of the injustice. These proposals were included in the "Goldman Sachs Historic Speech".

Conflicts of Interest: It is simply not credible to suggest that Goldman can effectively manage the multitude of conflicts that overwhelm the firm in its current form. Many industry participants marvel at how Goldman's PR machine has managed to quell the outrage over the years that logically should have erupted over the many conflict of interest abuses we have all observed. I will raise just one issue that is pertinent to current events:

Why is it that purchasing credit insurance on AIG after privately loading them up with tens of billions of credit default swaps on toxic subprime risk is not trading on inside information? And did Goldman keep buying protection from unsuspecting counterparties while their billion dollar collateral dispute with AIG remained out of the public's eye? If the answer is "it is not illegal to trade on inside information in the credit markets", I say, of course, it should be (and direct them to read Edmund Burke). Did Goldman also short AIG stock or buy puts? I am not as cynical as some who suggest that Goldman knew they would blow up AIG, that this was part of their intent. What is clear is that the hundred cents on the dollar they received from Uncle Sam was a windfall on top of their expected profit from the AIG strategy since they were able to profit from selling their AIG protection when it was no longer needed, *and*, they got all their money back on their AIG exposure from the taxpayers. Win-win! It is in this light that we are owed a better explanation of that fateful weekend at the Fed when Blankfein participated in discussions leading to the bailout of AIG.

But even assuming that Goldman did nothing illegal in relation to AIG, which I suspect is the case, I also prove my point: Goldman's business model is predicated on exploiting conflicts of interest, legal though such activity may be. We should ask, does Goldman purchase CDS protection on the debt of leveraged buyouts or recaps that its bankers advise on before such information becomes public? Did Goldman purchase CDS protection on Greece after it aided and abetted fraud by structuring off the books debt financing that only it knew about because the transactions were private?

It is possible to structure the financial industry so that conflicts of interest are minimized, not managed, much less "embraced". The "Goldman Sachs Historic Speech" provides some ideas with respect to Goldman. Others could improve upon them. A healthy and honest debate must begin on what activities can properly operate together, creating genuine diversity of risks and system resiliency, and what activities must properly be separated by law in order to enable trust in the system to be restored. What are we waiting for?

Hubris: I have nothing more to add with respect to Goldman Sachs.

So in the end, we are in a conundrum. Lacking the statesmanlike leadership within the financial sector that understands Edmond Burke's admonition, our government is faced with two bad options: a weak response will lead to greater and unacceptable debacles in the future, this much we can count on; too strong a response will entail unintended consequences, some potentially harmful to the real economy, and will necessitate bureaucratic inefficiency. Wall Street's failure to lead responsibly, with an ear to "what humanity, reason and justice tell me I ought to do" has left society with no choice.

There is much hard work ahead in creating a resilient and trusted financial system that serves the needs of the real economy rather than the self-interest of a few. More importantly, finance must evolve so it can fuel the transition of the real economy to respond to the injustice of gross and increasing wealth inequality, and, for the first time, to intelligently acknowledge the finite boundaries of the ecosystem that are in conflict with the finance driven global economy's never ending growth of material throughput.

This is the great work of our age. *Goldman v. United States* is the slap in the face we desperately need. Let's roll.

John Fullerton is the *Founder* and President of Capital Institute, and a former Managing Director of JPMorgan. During his 18 years at JPMorgan prior to the merger with Chase, John managed numerous derivatives and capital markets businesses around the globe. He was Morgan's representative on the Long Term Capital Oversight Committee that managed the rescue of Long Term Capital Management in 1998. He can be reached at jfullerton@capitalinstitute.org.