What-Ifs for Goldman Sachs

Behind Stiff Upper Lip, Some Executives, Alumni Consider Life After Blankfein

BY SUSANNE CRAIG
AND JOAN S. LUBLIN

SOME EXECUTIVES and powerful alumni of Goldman Sachs Group Inc. are talking about whether Chief Executive Lloyd C. Blankfein can survive the legal and public-relations storm swirling around the company, according to people familiar with the situation.

The conversations being held among some partners, managing directors and other current and former executives are informal, and there appear to be no plans for a management shake-up. The various hypothetical scenarios include whether Mr. Blankfein should resign, whether there should be a broader house-cleaning of top Goldman management or whether to separate the chairman and CEO posts now held by Mr. Blankfein.

In one possibility being discussed, Henry Paulson, who stepped down as Goldman's chief executive in 2006 to become Treasury secretary, would take the chairman job, these people said. But one person familiar with Mr. Paulson's thinking said he would never return to Goldman. Goldman declined to comment on the internal conversations.

On the surface, Mr. Blankfein's support remains unwavering as the New York company battles a federal criminal investigation and last month's civil-fraud lawsuit filed by the Securities and Exchange Commission. Less than a week after the suit was filed, Mr. Blankfein got a standing ovation at a meeting of Goldman executives, according to people who were there.

Nevertheless, the open discussions inside Goldman about life after Mr. Blankfein show that the firm is being rattled by the turmoil. In addition, several large Goldman shareholders said they support keeping Mr. Blankfein and President Gary D. Cohn in their current jobs. That endorsement could disappear, though, if the company suffers another "self-inflicted wound" that sinks its stock price, said one large investor.

Some shareholders said the tide could turn against Mr. Blankfein if Goldman shares fall below their current book value of about $122. The stock is down 19% since the SEC's lawsuit was filed but slipped just five cents on Tuesday to $149.65 in 4 p.m. New York Stock Exchange composite trading.

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ing, bucking the overall market's steep decline.

"We are very supportive of management and think the SEC case is weak, but at a certain point we can't afford not to ask for a management change," said one major Goldman shareholder, adding that the company needs to somehow escape its quagmire in the next month or so.

Goldman declined to comment on its investors. Allegiance to Mr. Blankfein among Goldman investors will be tested Friday at the company's annual meeting in lower Manhattan. Among seven shareholder proposals in the proxy statement is one that would split the posts of chairman and CEO, meaning Mr. Blankfein would have to relinquish his chairman duties.

Goldman's board has recommended voting against the proposal. The proposal is non-binding, but it could be hard for directors to ignore if it passes.

Julie Tanner, assistant director of socially responsible investing at Christian Brothers Investment Services Inc., the New York firm that proposed the move, said it could attract strong support even from shareholders who typically pay little attention to corporate-governance-related proposals.

"There is a lot of shareholder sentiment against the company right now," she said.

Proxy adviser Glass, Lewis & Co. supports the resolution, while rival RiskMetrics Group Inc. opposes it. Last year, 38 proposals favoring a separate chairman won an average of 34% of the votes cast, up from 28 proposals in 2008 that got an average of 29% support, according to a RiskMetrics analysis of about 7,500 U.S. companies it covers.

"I don't think splitting Goldman's two top roles would get the heat off them from the SEC, but it would be the right thing to do," said Gary Wilson, a former chairman of Northwest Airlines Corp. who now serves on the boards of Yahoo Inc. and CB Richard Ellis Group Inc.

If Mr. Blankfein steps down as chairman, top Goldman executives and alumni are discussing who might quickly fill the gap. One camp is pressing for Goldman's board to bring back Mr. Paulson as chairman.

While such a move might help restore confidence, it also could undermine Mr. Paulson's legacy as Treasury secretary during the financial crisis and fuel longstanding criticism that Goldman is a revolving door between Wall Street and Washington.

Arthur Levitt, a former chairman of the SEC who now advises Goldman on public policy and other matters, also has been raised as a possibility for chairman. The 79-year-old Mr. Levitt likely would refuse the post because it is too demanding given his age, said someone familiar with the situation.

Some investors expect the firm's troubles to end in a settlement with the SEC, which alleged that Goldman and trader Fabrice Tourre sold a collateralized debt obligation called Abacus 2007-AC1 without disclosing that hedge-fund firm Paulson & Co. helped to pick some of the underlying mortgage securities and was betting on the financial instrument's decline.

There are no signs of an imminent deal. Such an agreement could be one of the largest settlements in Wall Street history but will likely be difficult to reach, partly because the two sides are so far apart in their view of the firm's behavior. Some shareholders predict that Mr. Blankfein would have to resign as chief executive as part of a settlement with the SEC, a huge concession.

Goldman has said that all clients in the disputed Abacus deal were sophisticated investors who got the information they needed to make an informed decision. The SEC claims the firm duped investors with a product designed to fail.
He Knows Derivatives; but the Law?

By James B. Stewart

Warren Buffett may understand the complex derivative at the heart of the fraud suit against Goldman Sachs Group "better than most," as he put it this past weekend. But I'm not sure he understands the securities laws or the legal definition of fraud.

Mr. Buffett mounted a vigorous defense of Goldman, the embattled firm in which he is a major investor, arguing that the identity of the investor betting against the collateralized debt obligation—hedge fund manager John Paulson—would have been irrelevant to the investor betting on the underlying subprime mortgages. "For the life of me, I don't see whether it makes any difference," Mr. Buffett said at the Berkshire Hathaway annual meeting. This point has been echoed by many of Goldman's defenders, who note that the firm has no duty to disclose the identity of counterparties to trades in which the firm stands in the middle.

But the argument is a straw horse. The Securities and Exchange Commission didn't file a fraud case because Goldman failed to disclose Mr. Paulson's identity to potential counterparties. As the SEC itself said, "Goldman Sachs failed to disclose investors vital information about the CDO, in particular the role that a major hedge fund played in the portfolio selection process and the fact that the hedge fund had taken a short position against the CDO." The essence of the alleged fraud is that Goldman let the short seller choose some of the underlying subprime mortgages, failed to disclose that, and instead promoted the idea that an independent third party chose those securities. This is the material fact at the heart of the SEC's case. (Berkshire Hathaway didn't return calls seeking comment.)

With the Kentucky Derby in mind, let's consider a horse-racing analogy. There are just two horses and two bettors. The promoter offers you the opportunity to bet on one horse. Someone else is betting on the other. He doesn't tell you that the other bettor chose the two horses in the race, and picked one horse with no chance of winning. Instead, he says the horses were picked by an independent racing federation. You bet and lose. Would you feel that was fair?

I doubt it. Perhaps this is why most people seem to intuitively understand the SEC's case, unlike supposed experts like Mr. Buffett and others with a vested interest in seeing the SEC fail.

Goldman maintains the SEC's allegations are wrong. The firm deserves and is entitled to a fair hearing, unlike the show trial it endured at the hands of Congress last week. Why didn't the subcommittee call representatives of ACA Capital Management and German bank IKB, the alleged victims on the other side of Mr. Paulson's bet? As the purported victims in this fraud, how do they feel victimized? Or are they just sore losers?

Compounding the uncertainty is The Wall Street Journal's disclosure last week that Goldman is under criminal investigation. In a sense, this development shouldn't be a surprise: All fraud charges in the SEC's arsenal have criminal counterparts. Whether criminal charges ultimately emerge is usually a function of intent to defraud and whether the charges can be proved to the far higher criminal standard of beyond a reasonable doubt.

It is unlikely that the allegations in the SEC's civil case would be the focus of the Justice Department's inquiry. Ordinarily, the SEC defers to the Justice Department and lets criminal matters be resolved first. That suggests that something else is under scrutiny.

So the Justice inquiry takes the affair to another level. Criminal charges would be literally threatening, which is probably why Goldman shares dropped so sharply on the news last week. As the unfortunate example of accounting firm Arthur Andersen illustrates, even a highly respected institution can't survive the filing of criminal charges by the U.S. government. Few seem to remember that Arthur Andersen's conviction was ultimately overturned on appeal. By then the firm was defunct.

Arthur Andersen made the mistake of outright defiance, which is why I've counseled Goldman to get all the facts out as soon as possible.

Plenty of questions in this case remain unanswered, which is why it is risky for Mr. Buffett to get too far out on the Goldman limb before the facts are known. So far he hasn't said he is putting his money where his mouth is by increasing his stake in Goldman. Until more facts are known and some of the legal uncertainties are resolved, potential investors should recognize that buying Goldman shares is like the derivative transaction at the heart of the SEC case: a speculative bet.

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Goldman Unit Is Disciplined On Short Bets

BY JACOB BUNGE

The Securities and Exchange Commission and the regulatory arm of NYSE Euronext disciplined an equities unit of Goldman Sachs Co. on Tuesday for alleged violations of rules on short selling stocks.

In December 2008 and January 2009, Goldman Sachs Execution Clearing LP allegedly failed to buy enough shares to cover short positions held by customers, according to a notice from NYSE Regulation.

The issue was compounded as the firm continued to accept hundreds of short-sale orders in stocks in which it hadn’t obtained enough shares to cover clients’ existing short positions.

Short selling is a practice in which investors borrow shares and sell them to another investor, aiming to buy them back after their value has gone down and pocketing the difference. The practice is legal, but U.S. regulators have tightened up rules to ensure that investors actually hold the shares that they are lending out.

Tuesday’s disciplinary action represents the first case pressed by regulators based on new rules put in place in the fall of 2008 to curb so-called naked short selling, in which investors short stocks that they don’t possess.

The action comes as Goldman Sachs grapples with SEC charges of fraud tied to its dealings in the mortgage market, where the Wall Street bank stands accused of stacking the deck against its own clients.

A spokesman for the agency declined to comment on whether Tuesday’s disciplinary action tied into the scrutiny of Goldman’s mortgage business.

Goldman Sachs Execution Clearing and Goldman Sachs Co. are units of parent company Goldman Sachs Group Inc.

The firm neither admitted nor denied the findings announced Tuesday. Both NYSE Euronext and the SEC censured Goldman Sachs Execution Clearing, and the firm will pay $450,000 in fines, split between the SEC and NYSE Regulation.

A spokesman for Goldman Sachs said the issue was the result of “an inadvertent, manual processing error” following the change to short-selling rules in October 2008. There was no financial impact on clients, he said.
Goldman Visits the Court of Public Financing

Municipal-Debt Issuers Hear the Bank’s Side of the Case; Still, Concerns Abound as Executives Scramble to Buff Image

BY RANDALL SMITH

In the weeks since Goldman Sachs Group Inc. was sued over alleged fraud, the firm has engaged in a charm offensive to keep customers from defecting. But it hasn’t always worked.

Goldman sent out emails to clients on the day of the allegations, April 16, giving its defense. Since then, Goldman executives have crossed the country to meet with clients. One Goldman insider said colleagues crammed roughly two months of client visits into two weeks.

Last week, the $9 billion Oklahoma Teachers Retirement System voted to put Goldman’s asset-management unit “on alert” for possible termination pending a review of the allegations as “an organizational concern.”

Other clients say they are concerned as well. The Securities and Exchange Commission accused the firm of failing to disclose the role of a short seller in constructing a pool of mortgage-related assets sold to investors. Goldman has denied wrongdoing, saying its disclosures were adequate. A related criminal investigation disclosed last Friday and congressional hearings on April 27 focusing on the charges have intensified scrutiny of the firm.

The action by Oklahoma, which was earlier reported by Reuters, shows how state and local governments can be sensitive to such issues for political reasons. Goldman has ranked No. 5 in U.S. municipal underwriting in the years 2007 through 2009, according to Thomson Reuters. This year it ranks No. 6.

Such issues by state and local governments and authorities, many of them tax-exempt, are used for public purposes such as schools, sewers and water systems-financing projects often launched by elected officials and closely scrutinized by taxpayers. Some public-finance experts say politics often plays a role in underwriter selections.

“I think in the municipal world, people are more sensitive to some of these issues just because of the political environment in which they live,” says municipal-bond lawyer Dee Wisor of the Denver firm Sherman & Howard LLC. Goldman declined to comment for this article.

“People are talking and this can’t help them,” said Brian Thomas, chief financial officer of the Metropolitan Water District of Southern California, which has issued notes through under-
writers including Goldman.

Goldman has met clients "to discuss any concerns they may have with the firm," according to Brad Hintz, a securities analyst at Sanford C. Bernstein & Co. who met with top Goldman executives Friday. The upshot: Goldman has seen "no degradation of business," has been winning assignments it expected to win and "trade flows remain in line with expectations," he added.

Some Goldman clients say they will have to see the whole case unfold before making longer-term decisions. "We're at this time very pleased with the services they provide," said James Fuller, chief financial officer of the Municipal Electric Authority of Georgia, which issued $2.7 billion of debt with Goldman as a senior manager in March. "We would like to see the situation play out and see what happens before we make any rash decisions."

Other public officials aren't waiting. Chris Street, the Treasurer-Tax Collector of Orange County, a member of the county's public-finance advisory committee, last Friday called for "hearings to review the appropriateness of retaining Goldman Sachs" as an Orange County, Calif., underwriter.

In an email to Huntington Beach, Calif., Treasurer Shari Freidenrich, who heads the public-finance panel and is running for the Orange County Treasurer post that Mr. Street is vacating, Mr. Street cited the fraud charges filed in April.

In her reply, Ms. Freidenrich told Mr. Street that he was free to bring up the issue at the panel's next meeting on Thursday. "Then the board can decide if it would like to place this on a subsequent board agenda." Ms. Freidenrich referred a call to a county spokesman, who said that while Goldman is on a list of qualified underwriters, the firm hasn't done financing work for the county since 2006 and isn't under consideration for current assignments.