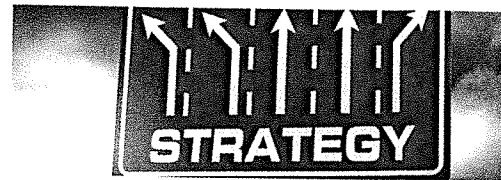


STRATEGY SIGN ON

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Strategic Management Project: Module 11

This module deals with the relationships your company has with its major stakeholder groups. With the information you have at your disposal, perform the tasks and answer the questions that follow:

1. Identify the main stakeholder groups in your company. What claims do they place on the company? How is the company trying to satisfy those claims?
2. Evaluate the performance of the CEO of your company from the perspective of (a) stockholders, (b) employees, (c) customers, and (d) suppliers. What does this evaluation tell you about the ability of the CEO and the priorities that he or she is committed to?
3. Try to establish whether the governance mechanisms that operate in your company do a good job of aligning the interests of top managers with those of stockholders.
4. Pick a major strategic decision made by your company in recent years, and try to think through the ethical implications of that decision. In the light of your review, do you think that the company acted correctly?

CLOSING CASE

Did Goldman Sachs Commit Fraud?

In the mid-2000s, when housing prices in the United States were surging, hedge fund manager John Paulson approached Goldman Sachs. Paulson believed that housing prices had risen too much. There was, he felt, a speculative bubble in housing. In his view, the bubble had been fueled by cheap money from banks. The banks were enticing people to purchase homes with adjustable-rate mortgages with very low interest rates for the first 1 to 3 years. Many of the borrowers, however, could probably not afford their monthly payments once higher rates would later begin. Paulson thought that homeowners would start to default on their mortgage payments in large numbers. When that happened, the housing market would be flooded with distressed sales and house prices would collapse. Paulson wanted to find a way to make money from this situation.

Goldman Sachs devised an investment vehicle that would allow Paulson to do just this. During the early 2000s, mortgage originators had started to pool thousands of individual mortgages together into bonds known as collateralized debt obligations, or CDOs. They then sold the bonds to institutional investors. The underlying idea was simple: the pool of mortgage payments generated income for the bondholders. As long as people continued to make their mortgage payments, the CDOs would generate good income and their price would be stable. Many of these bonds were given favorable ratings from the two main rating agencies, Moody's and Standard & Poor's, suggesting that they were safe investments. At the time, institutional investors were snapping up CDOs. Paulson, however, took a very different view. He believed that the rating agencies were wrong and

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that many CDOs were far more risky than investors thought. He believed that when people started to default on their mortgage payments, the price of these CDOs would collapse.

Goldman Sachs decided to offer bonds for sale to institutional investors that were a collection of 90 or so CDOs. These bonds were referred to as *synthetic CDOs*. They asked Paulson to identify the CDOs that he thought were very risky and grouped them together into *synthetic CDOs*. Goldman then sold these very same bonds to institutional investors—many were long-time Goldman Sachs clients. Goldman did not tell investors that Paulson had helped to pick the CDOs that were pooled into the bonds, nor did the company tell investors that the underlying CDOs might be a lot more risky than the rating agencies thought. Paulson then took a short position in these synthetic CDOs. Short selling is a technique whereby the investor will make money if the price of the asset goes down over time. Paulson was effectively betting against the synthetic CDOs, a fact that Goldman knew, while he was actively marketing these bonds to institutions.

Shortly thereafter, Paulson was proved correct. People did start to default on their housing payments, the price of houses did fall, and the value of CDOs and the synthetic CDOs that Goldman had created plunged. Paulson made an estimated \$3.7 billion in 2007 alone from this event. Goldman Sachs, too, made over \$1 billion by betting against the very same bonds that it had been selling.

The SEC soon started to investigate the transactions. Some at the SEC believed that Goldman had knowingly committed fraud by failing to inform buyers that Paulson had selected the CDOs. The SEC's case was strengthened by internal Goldman e-mails. In one, a senior executive described the synthetic CDOs it was selling as "one shitty deal." In another, a colleague applauded the deal for making "lemonade from some big old lemons."

In April 2010, the SEC formally charged Goldman Sachs with civil fraud, arguing that the company had knowingly mislead investors about the risk and value of the synthetic CDOs, and failed to inform them of John Paulson's involvement in selecting the underlying CDOs. Goldman provided a vigorous defense; it argued that a market maker like Goldman Sachs owes no fiduciary duty to clients and offers no warranties—it is up to clients to make their own assessment of the value of a security. However, faced with a barrage of negative publicity, Goldman opted to settle the case out of court and pay a \$550 million fine. In doing so, Goldman admitted no legal wrongdoing, but did say that the company had made a "mistake" in not disclosing Paulson's role, and vowed to raise its standards for the future.

Sources: L. Story and G. Morgenson, "SEC Accuses Goldman of Fraud in Housing Deal," *New York Times*, April 16, 2010; J. Stempel and S. Eder, "Goldman Sachs Charged with Fraud by SEC," *Reuters*, April 16, 2010; and "Sachs and the Shitty," *The Economist*, May 1, 2010.

CASE DISCUSSION QUESTIONS

1. Did Goldman Sachs break the law by not telling investors that Paulson had created the synthetic CDOs and was betting against them? Was it unethical for Goldman Sachs to market the CDOs?
2. Would your answer to the question above change if Goldman had not made billions from selling the CDOs? Would your answer to the question above change if Paulson had been wrong, and the CDOs had increased in value?
3. If opinions vary about the quality or riskiness of an investment, does a firm like Goldman Sachs owe a fiduciary duty to its clients to try to represent all of those opinions?
4. Is it unethical for a company like Goldman to permit its managers to trade on the company's account (i.e., invest on the company's behalf rather than an external client's behalf)? If not, how should compensation policies be designed to prevent conflicts of interest from arising between trades on behalf of the firm and trades on behalf of clients?