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Embracing Conflicts – A Bad Business Strategy

Goldman Sachs may or may not be guilty of fraud as alleged by the Securities and Exchange Commission. The legal issue centers on whether Goldman had to disclose that a prominent institutional investor had selected mortgages to be sold to other institutional investors. "Disclosure" is the central issue in this case.

There is a much more basic business issue raised by the case; namely, when a firm represents itself and other parties simultaneously, to whom do they have a fiduciary responsibility?

For most of my 50 years on Wall Street, it was assumed that your firm could only represent one party in a transaction. This was not only good business practice but legal advisors cautioned against conflicts of interest and the courts dealt harshly with a participant who tried to wear two hats.

As Wall Street firms expanded and moved into proprietary investments, leveraged or not, short and long-term, debt or equity, departments arose to resolve not only conflicts within the firms but also conflicts with their clients. Jargon was created, such as Chinese Walls and Clean Teams, to camouflage what is dubious behavior – representing competing interests under the same roof – one of which increasingly is the firm itself.

Ambiguity and self-interest have become the standards in the diversified firms, replacing loyalty and trust.

Charlie Ellis, in the updated version of his history of Goldman Sachs, interviewed the current CEO extensively. Ellis writes:

"The crucial differentiating advantage of Goldman Sachs would be one that outsiders might find surprising: Its complex variety of many businesses was sure to have lots of conflicts. Goldman Sachs, Blankfein said, should embrace the challenge of those conflicts. Like market risk, the risk of conflicts would keep most competitors away – but by engaging actively with clients, Goldman Sachs would understand these conflicts better and could manage them better".

Ellis goes on to quote Blankfein directly:

"If major clients – governments, institutional investors, corporations, and wealthy families – believe they can trust our [Goldman Sachs] judgment, we can invite them to partner with us and share their success."

There are a number of points worth noting. First, managing conflicts or competing with your clients may be good business for a securities firm but how can it be better for the client?

Second, from a client's perspective, when and how fully does he receive the disclosure that his agent is actually competing with him, and when and how is he able to evaluate fully that information? Over a decade ago, it was conclusively demonstrated that financial firms could not resolve conflicts between clients using securities research and the firms' drive to obtain underwriting business. The internal barriers were scaled whenever management wanted. Citigroup, for one, was forced to hive off its research. Safeguards were enacted to increase transparency and limit potential conflicts in securities research.

Third, from a management point of view, how do you monitor the conduct of your employees to be sure they are informing their clients sufficiently? In the present Goldman Sachs case, a 31 year old vice president apparently had enough independent authority to make this judgment.

When I left Lehman Brothers over 21 years ago, I noted this problem and quipped "I didn't want my reputation or net worth dependent on people I didn't know, trading securities I didn't fully understand in places I rarely visited." That was over two decades ago and the now mightier firms tout the extent of their reach in much larger global markets. Even the best managed firm cannot police conflicts with their clients.

Fourth, what happened to the concept of fiduciary responsibility and loyalty to your clients as opposed to your firm's interests? Without sounding like Little Mary Sunshine, the enduring firms, such as JP Morgan and Goldman, were built on relationships with clients – corporate and personal – nurtured over decades.

There is a legal issue as well best expressed by then Judge Benjamin Cardozo of the Court of Appeals of New York in 1928. In the case of *Meinhard v. Salmon*, Judge Cardozo opined,

"...copartners owe to one another.... the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."

Since 1928, hundreds of cases have defined the relationship between agents and their clients. In thinking about the conduct of financial firms, the words of Cardozo resound.

Fifth, an argument is frequently made that in the capital markets, a securities firm simply runs the casino, likened to a craps table in Las Vegas. There is nothing neutral, however, about proprietary trading or investments which often compete with clients.

As we debate restructuring the financial markets, no legislation nor regulatory reform would rekindle more trust in the markets than a recognition by the managements of these behemoths that competing with your clients is a bad business practice, will hurt one's franchise and undermine the integrity of the markets.

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