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Scrutiny of Goldman's Board Focusing on Silence Over Conflicts

By Richard Teitelbaum

Greg Palm, Goldman Sachs Group Inc. general counsel, took a call in his 37th-floor office at One New York Plaza on Dec. 16, 2008. It was his old boss, Stephen Friedman, a former Goldman chairman who was then head of the audit committee of its board of directors. Goldman's stock was down 65 percent from its 52-week high during an accelerating global financial breakdown.

Friedman, who had become chairman of the Federal Reserve Bank of New York that year, told Palm he wanted to buy, Bloomberg Markets magazine reports in its August issue.

Palm says he couldn't think of a reason why Friedman shouldn't: Goldman had made the necessary disclosures in that day's filings, Palm says.

"We'd just reported earnings," says Palm, whose job includes approving trades by directors. "There was no material information that wasn't public from Goldman's standpoint."

Friedman, 72, who is still a Goldman director, bought 37,300 shares at an average of \$80.78 each on Dec. 17. Five weeks later,

he picked up 15,300 more at an average of \$66.61. By yesterday, the stock had doubled to \$133.76, giving Friedman a paper profit of \$3 million.

Now, the U.S. House Oversight and Government Reform Committee is investigating Friedman's stock purchases. It wants to know why he was permitted to buy stock in a bank he was regulating as chairman of the New York Fed.

Friedman held both that post and his Goldman board seat when the firm became a bank holding company in September 2008. The Federal Reserve Act forbids an official at the New York Fed in his position from also being a director of a bank or buying its stock.

'Perfectly Legal'

The New York Fed sought a waiver from the Federal Reserve Board in September 2008 so that Friedman could keep his position there. Michele Davis, a spokeswoman for Friedman, says New York Fed general counsel Tom Baxter told Friedman that the

rules were in abeyance while the waiver was pending.

"Therefore, Mr. Friedman's purchases of Goldman Sachs stock were perfectly legal," she says. The waiver was granted in January 2009.

Jerry Jordan, a former president of the Cleveland Fed, says the section of the Federal Reserve Act barring Friedman from owning bank stock or buying new shares could not be waived. "It was not allowed," he says. "You can't get permission to violate the law."

Keeping Mum

Goldman Sachs's ties to the New York Fed pose another potential conflict for Friedman, says James Cox, a professor at Duke University School of Law. Goldman was a prime beneficiary of the New York Fed-engineered bailout of American International Group Inc.'s bank counterparties, receiving, by its own count, \$12.9 billion for the credit protection it held on mortgage-related securities. That figure was not publicly disclosed by AIG until March 2009 -- after Friedman had bought his shares.

"It raises at the least an eyebrow in terms of what he knew about those payments," Cox says.

New York Fed spokesman Jack Gutt responds: "Friedman had no involvement in nor was he provided with confidential information related to the New York Fed's negotiation with any AIG counterparties."

Friedman resigned from the New York Fed on May 7, 2009, days after the Wall Street Journal reported his stock buying. At the time, Baxter said in a statement, "It is my view that these purchases did not violate any Federal Reserve statute, rule or policy."

As the Friedman saga unfolds -- and Goldman's regulatory and legal entanglements escalate -- the firm's nine outside directors, who aren't Goldman employees, are keeping mum.

'Completely Unfounded'

The board members said nothing publicly, for instance, when on April 16 the U.S. Securities and Exchange Commission filed a civil suit alleging Goldman had committed fraud in underwriting and marketing a mortgage-related security called Abacus 2007-AC1 without disclosing to clients that a bearish hedge fund customer, Paulson & Co., was involved in creating it.

Goldman calls the SEC suit "completely unfounded."

Federal prosecutors in New York are also investigating Goldman transactions to determine whether to pursue a criminal fraud case, according to two people familiar with the matter.

Nell Minow, co-founder of the Portland, Maine-based Corporate Library, a governance research firm, says that when the SEC suit was filed, the outside directors should have immediately set up a committee to investigate, hired independent counsel and announced that they would make the results of their probe public.

Wells Notice

The board should also have been riding herd on its members' stock trades, says Cornell University Law School Professor Robert Hockett, who specializes in financial regulation from his office in Ithaca, New York. Goldman spokesman Lucas van Praag says directors are periodically informed of such trades. The bank received a Wells notice dated July 28, 2009, notifying the firm that it was the target of an SEC fraud investigation.

At least three company executives, including Vice Chairman Michael Evans, unloaded more than \$27 million of Goldman stock from October 2009 through February 2010 in open market sales unrelated to the recent exercise of options or delivery of

restricted stock, according to data compiled by Bloomberg.

Van Praag says Goldman's board was informed of the Wells notice, which was not made public until after the SEC filed its suit. He says the firm's lawyers determined it wasn't material.

"On the face of it, the idea that that would not be material -- I can't imagine anybody saying that with a straight face," Hockett says.

11-Hour Hearing

Jacob Zamansky of Zamansky & Associates LLC filed a class- action lawsuit on April 30 on behalf of Goldman shareholders, saying that Goldman made false statements relating to the SEC suit and failed to disclose adverse facts about the company to shareholders.

"The Wells notice was a material fact going to the heart of their business," he says. Goldman had not formally responded to the suit as of late June.

The number of issues Goldman executives, and their board, need to address continues to build.

Director Rajat Gupta did not stand for re-election to the board in May. U.S. investigators suspect him of leaking word of a \$5 billion investment in Goldman by Berkshire Hathaway Inc. in 2008, according to a person with knowledge of the matter.

Gary Naftalis, a lawyer for Gupta, former worldwide managing director of McKinsey & Co., says, "Rajat Gupta has never violated any law or rule."

A Billion Pages

On April 27, the Senate Permanent Subcommittee on Investigations held an 11-hour hearing on Goldman's role in the financial meltdown.

"Goldman repeatedly put its own interests and profits ahead of the interests of its clients and our communities," Senator Carl Levin, a Michigan Democrat, said at the hearing.

"We respectfully disagree," van Praag says.

On June 7, the Financial Crisis Inquiry Commission subpoenaed Goldman, accusing it of attempting to hinder its probe of the firm by electronically sending it the equivalent of more than a billion pages of documents. Yesterday the leaders of the commission told journalists in a conference call that the firm has become more responsive.

"The outside directors haven't been visible on any of this," says Patrick McGurn, special counsel at RiskMetrics Group, a New York adviser to shareholders. "You have to ask if it's setting the correct ethical tone." Van Praag says: "Board chairman Lloyd Blankfein has made the views of the board well-known."

Speaking Out

Goldman's board consists of two insiders, Chairman and Chief Executive Officer Blankfein and President Gary Cohn, and nine outsiders. There are five scheduled meetings per year and more as needed, the company says.

The outside directors are: Friedman; Lois Juliber, 61, former vice chairman of Colgate-Palmolive Co.; William George, 67, ex-CEO of Medtronic Inc.; Lakshmi Mittal, 60, CEO of steelmaker ArcelorMittal; John Bryan, 73, ex-CEO of Sara Lee Corp.; Lee Scott, 61, ex-CEO of Wal-Mart Stores Inc.; Claes Dahlback, 63, ex-CEO of Sweden's Investor AB; James Johnson, 66, vice chairman of merchant bank Perseus LLC and former CEO of Fannie Mae; and James Schiro, 64, former head of insurer Zurich Financial Services AG.

Directors who completed a full year in 2009 were paid an average of \$460,852 in stock and options compared with \$255,519 in cash and stock for JPMorgan Chase & Co.'s 10 outside directors and \$337,803 for Morgan Stanley's 11 outsiders, proxies show.

Goldman's board may have been able to preempt criticism of the company by speaking out, says Sean Coffey, a former partner at Bernstein Litowitz Berger & Grossmann LLP, who's running for New York state attorney general.

Shopping at Walmart

The board should have established a committee of outside directors with an independent counsel to investigate ethics matters and get the facts, says Coffey, who won more than \$50 million from WorldCom Inc. directors in a 2005 settlement with the telecom company.

"The right decision might be to take out advertisements and apologize or it might be to batten down the hatches," Coffey says. "Don't omit disclosing material information that investors ought to know."

Minow says the Goldman board should have nominated someone who had securities law enforcement experience, who could have led an internal investigation.

Instead, in March, Goldman nominated -- and shareholders later approved -- the appointment of Walmart's Scott. After an exchange in which a person at the May 7 annual meeting asked how Scott had been selected, CEO Blankfein deadpanned, "Actually, I like shopping at Walmart."

Nine-Person Board

At the meeting, Goldman announced the creation of an internal committee that will examine possible conflicts of interest and other issues such as transparency and disclosure. It's headed by Vice Chairman

Evans and E. Gerald Corrigan, chairman of Goldman Sachs Bank USA. No board members are involved.

Former eBay CEO Meg Whitman, who joined Goldman's board in 2001, says then-CEO Henry Paulson brushed aside her questions to move a meeting along.

"They wanted to keep acting like a group of partners who did much of their discussion and decision-making in private and then expected to get the board's rubber stamp," Whitman writes in her new book, *The Power of Many* (Crown, 2010). She resigned after 15 months.

Whitman is now the Republican candidate for governor of California.

Cornell's Hockett says that if Friedman violated any laws, the entire Goldman board is to blame.

"Boards are intended to police the actions of their members," he says.

Class C

Friedman spokesperson Davis says the waiver exonerates him.

The New York Fed's nine-person board consists of three classes of directors serving staggered terms. Class A directors are elected by member banks to represent commercial banks; one class A director today is JPMorgan Chase Chairman and CEO Jamie Dimon. Class B directors are elected by member banks to represent the public, while class C directors such as Friedman, who also represent the public, are appointed by the Fed Board of Governors.

Former Cleveland Fed President Jordan says the law is clear: As a Class C director, Friedman could not own, much less buy, bank stock.

Section 4, Number 15 of the Federal Reserve Act reads, "No director of class C shall be an officer, director, employee, or stockholder of any bank."

The New York Fed argued that because Goldman was a bank holding company and not a bank, a waiver could be granted, according to a person with knowledge of the matter. The Fed agreed.

Shares Surge

How much the Goldman board's silence in the face of adversity has cost the firm is difficult to gauge. Goldman shares have surged 157 percent as of June 29 since hitting an all-time low in November 2008. In May, shareholders approved those directors standing for election by margins of more than 95 percent or greater.

Still, says Coffey, the board's somnolence in the face of so much controversy has done nothing to support Goldman's storied franchise.