Being 'legal' doesn't make it 'right'

Q: Goldman Sachs promises to put customers' interests first. At the same time, Goldman was able to avoid serious financial trouble by hedging positions in ways that placed bets against clients. Do Goldman's leaders need a new business strategy, or do they need to just do a better job at explaining their business to regulators and the public?

Great companies have to distinguish between what is legal and what is right.

An important cause of Goldman's problems---a problem shared by the financial services industry---is that they fail energetically and rigorously to make this distinction in their communications with regulators and the public.

Whether Goldman's past behavior was "legal"---either in the particular matter being pursued by the SEC or its pattern and practice in the mortgage market under scrutiny by the Congress---is judged under at least three related standards:

- Did the behavior conform to specific legislative or regulatory rules (i.e. proper disclosure of role of "shorts" or of its receipt of a Wells notice from the SEC)?

- Did it conform to broad precepts of law, like its fiduciary duties, that may be created by judges in evolving series of cases (and then, at times, incorporated into regulatory regimes)?

- Did it comport with "common industry practices" of the time which were not then illegal?

The problem both for Goldman and for the financial services industry is that, as a nation, we are in tumultuous and confusing transition from a deregulated financial services industry to an industry that will be subject to greater regulation (assuming financial services legislation will pass in some form.) It's a very messy transition of changing expectations.
This problem is accentuated by the complexity of the problems, the multiplicity of actors and the difficulty those actors and the media have in explaining complex facts and policy choices clearly.

But, in such an era, the "it was legal" defense is inadequate because regulators and the public (and some customers) are asking "is it right?"

Two related examples.

First, Goldman is defending against the SEC complaint in the court of public opinion by saying that the synthetic CDO was a transaction between sophisticated parties ("consenting adults," ) that everyone knew there would be a long and short side of the transaction, that it did not mislead the long side of the transaction, which had every incentive to understand the CDOs packaged in the instrument.

But, the underlying question is whether a synthetic CDO transaction---which is unrelated to the "real economy," just a bet between well-heeled parties that creates significant economic risk---is "right." There is a strong view that these transactions are not right. Goldman needs to defend not only its actions in the particular case but also take a position on whether such transactions are appropriate and under what conditions.

It should be possible for Goldman to address the real issues. It could defend itself under past law if it truly believes it is not culpable in a technical legal sense but also acknowledge that this type of high-risk institutional gambling creates unacceptable risks going forward (or should be modified in some significant way).

Second, there is now a confusing debate about whether and how to regulate derivatives transactions, which in the years before the melt-down grew from hundreds of billions to trillions of dollars in unregulated risk. Here the financial-services industry appears to be just saying "no" to a transparent clearinghouse with clearer collateral requirements and a lessening of risk.

But, for most regulators and for the public (to the extent it can understand such complex instruments), this answer of "it was legal" in the past and should be in the future is inadequate. Their justification appears to be to allow financial institutions to make outsized profits. Major financial players -- and it is too much too expect that the "industry" would speak with one voice -- need to address the "what is right" question with a more complete assessment of the interests at stake and a more compromised position. Can it really be that there should be no regulation of these instruments?

To be sure, explaining that past behavior was legal (if it was) and defining what is "right" for future behavior is extremely difficult in a heated, politicized, partisan atmosphere with a complex subjects and a fragmented media. And the media is far more inclined to focus on
conflict and culpability than complex debates about critical details about future reform, even when some corporate actors may suggest reform positions in white papers or testimony (Goldman has broadly supported many of the elements of financial services reform).

But Goldman's problem, as it faces an energized pounding from Congressional and SEC investigators, is being credible on that critical distinction for regulators, customers and the public: What it did in the past may have been "legal" under past standards and consistent with industry practice but a different standard of "what is right" should apply in the future.

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