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Goldman Sachs Stock, Board Under Pressure Amid Probe (Update2)

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(Adds Brown comment in thirteenth paragraph.)

By Christine Harper

April 19 (Bloomberg) -- Goldman Sachs Group Inc.'s stock may drop and the board could come under pressure to change managers after European politicians followed a U.S. fraud suit with their own plans to scrutinize the firm, investors said.

Prime Minister Gordon Brown called yesterday for the U.K. Financial Services Authority to start a probe, saying he was "shocked" at the "moral bankruptcy" indicated in the Securities and Exchange Commission suit against Goldman Sachs. Germany's financial regulator, Bafin, asked the SEC for details on the suit, a spokesman for Chancellor Angela Merkel said.

The escalating rhetoric adds urgency to efforts by Chairman and Chief Executive Officer Lloyd Blankfein and the rest of his board to stem the negative publicity. Although Goldman Sachs vowed to fight the SEC case, calling it "unfounded in law and fact," the stock fell 13 percent on April 16. The shares rose 0.3 percent to \$161.19 in European trading today.

"The lynch-mob mentality that is prevailing right now against Goldman is such that you don't know where this thing could go, so I think the stock is going to be under continuing pressure," said Michael Holland, who oversees more than \$4 billion as chairman of New York-based Holland & Co. "The board actually has to pay attention not only to the legal niceties of this thing but also to the franchise viability as well."

Michael Farr, president and founder of Washington-based Farr, Miller & Washington LLC, said he sold his Goldman Sachs stock on April 16 because the SEC suit brought the controversy over Wall Street's dealings in collateralized debt obligations and credit-default swaps to a new level.

'Investors Understand Fraud'

"Investors understand that something complicated and errant happened with CDOs and CDSs but they're not sure entirely what, because these collateralized debt obligations and credit-default swaps are complicated and somewhat arcane," said Farr, whose firm manages more than \$700 million in assets. "But investors understand fraud, they get fraud really clearly."

Samuel Robinson, a spokesman for Goldman Sachs, declined to comment.

The SEC said that in early 2007, as the U.S. housing market teetered, Goldman Sachs created and sold a CDO linked to subprime mortgages without disclosing that hedge fund Paulson & Co. helped pick the underlying securities and bet against the vehicle, known as Abacus 2007-AC1.

Goldman Sachs, whose \$13.4 billion profit last year was the highest ever for a Wall Street securities firm, is facing an unprecedented level of public opprobrium because of the perception that it profited from practices that led to the biggest financial crisis since the Great Depression.

'The Bogey Man'

"Goldman Sachs will now become the bogey man for all financial ills and I think it's a story that's not going away, it is only likely to increase," said Matt McCormick, an analyst at Bahl & Gaynor Inc. in Cincinnati, which manages about \$2.8 billion. "If you buy it at these levels you are hoping that this is the worst of the bad news and I don't believe that's the case."

Steve Stelmach, an analyst at FBR Capital Markets in Arlington, Virginia, today removed Goldman from his 'Top Picks' list, citing the SEC suit. He still reiterated his outperform rating because of the bank's "strong fundamentals."

"The market appears to be overly discounting the potential earnings impact from the SEC charges," he wrote in a note to clients today. The stock's drop implies the suit may cost the bank \$2 billion before tax, twice the \$1 billion the SEC says investors lost in the transaction, he wrote.

'Answer Questions'

Of the 29 analysts that track Goldman, 22 rate the stock a buy, seven mark it a hold and none recommend investors sell, data compiled by Bloomberg show.

Politicians that were forced to bail out their nations' banks are turning on Goldman Sachs. The firm, which paid its employees \$16.2 billion last year, has become a target for politicians like the U.K.'s Brown who are running in elections or who, in the U.S., are battling over new financial regulation.

"It is individuals in Goldman Sachs that are going to have to answer questions," Brown said at an event in London today. "We are determined to root out any malpractice."

The European Union is probing Goldman Sachs's role in arranging swaps for Greece that may have masked the country's budget deficit. Congress has also examined the company's relationship with American International Group Inc., which got a \$182.3 billion U.S. rescue.

Federal Case Assigned

The SEC case against Goldman Sachs was assigned to U.S. District Judge Barbara Jones in New York who presided over the case of former WorldCom Inc. CEO Bernard Ebbers. Ebbers, who was convicted in 2005 of overseeing one of the biggest frauds in U.S. history, is serving a 25-year prison term.

Goldman Sachs's first-quarter profit, due to be published tomorrow, probably won't help even though analysts expect earnings to rise 41 percent from a year earlier, McCormick said.

"They're going to probably come out with great earnings, at least that's the expectation, but that is going to be quickly discounted and drowned out," he said.

Goldman Sachs's board of directors should do its own investigation to ensure that it understands what senior management knew about the issues raised by the SEC's complaint, said James Post, a professor of corporate governance and ethics at the Boston University School of Management.

'How Long?'

"The board has got to be insisting on a much deeper level of internal investigation that reports only to them, not to Blankfein," Post said. "They've got to be asking the question 'how long can we continue going with Blankfein before we've got to clean house and put a new group of people in there?'"

William W. George, a Harvard Business School professor who has served on Goldman Sachs's board since 2002, referred a request for an interview to the company's press office. His Twitter account, which lauded JPMorgan Chase & Co. CEO Jamie Dimon for his firm's better-than-expected earnings on April 14, remained silent on the controversy surrounding Goldman Sachs.

Boston University's Post said he wouldn't expect the board to take any immediate action to change the firm's management because it would seem to contradict the defiant position the company took on April 16.

"I'm pretty sure that the board at Goldman is having a bad weekend," Post said on April 18. "They may be praying for some news out of the Vatican or a new volcano to get them off the front pages."

Management Changes?

Bahl & Gaynor's McCormick said changing senior management could add fuel to critics' complaints instead of mollifying them. A better course, he said, would be to bring in a well-respected Wall Street veteran, even someone like billionaire Warren Buffett, to serve as a chairman or adviser to Blankfein. Buffett's Berkshire Hathaway Inc. is already one of the largest investors in Goldman Sachs.

"I could see them bringing in an outside person, somebody who is viewed by the Street as a wise sage that could come in and give an outsider's perspective" to advise Blankfein, McCormick said. "Nobody's going to believe Goldman is going to take care of this on their own."

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