The Goldman Sachs Abacus 2007-ACI Controversy: An ethical case study

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I. Overview

Goldman Sachs is one of the most profitable and powerful investment banks in the world today. In Charles Ellis's disquisition of Goldman's rise to the top, *The Partnership*, he remarks that in the last sixty years, Goldman has gone from being a "marginal Eastern U.S. commercial paper-dealer" to a "global juggernaut, serially transforming itself from agent to managing agent to managing partner to principal investor with such strengths that it operates with almost no external constraints in virtually any financial market it chooses…" (Ellis 2008).

When the financial markets crashed in 2008, Goldman did not come away unscathed. It was able to survive the meltdown by turning into a commercial bank holding company and took on federal assistance (Story 2009). The company was the first Wall Street company to pay back its bailout money in 2009, but came under the radar again as its "hardball tactics and super-sized profits drew new scrutiny and criticism" (ibid). On April 16, 2010, the Securities and Exchange Commission (S.E.C.) filed a civil suit against the mega-firm, accusing the company of committing securities fraud, in which the bank created and sold a mortgage investment "that was secretly devised to fail" (Schrieber 2011).

The security in question, Abacus 2007-ACI (Abacus), had been created for John Paulson, the manager of the hedge fund Paulson & Company, and one of Goldman's institutional clients (ibid). Meanwhile, another investment client, ACA Management LLC (ACA) met with Goldman traders to discuss potential mortgage investments. The S.E.C. felt that in these meetings, Goldman "deliberately misled the company to believe that Paulson & Company was also investing in Abacus" when in actuality, Paulson & Company was making the "opposite investment wager, with the expectation that Abacus would lose money" (ibid). By October 24, 2007, 83% of the mortgage-based securities had been downgraded and by January 29, 2008, 99% of the entire portfolio had been downgraded and designated as virtually worthless (ibid). So as the Abacus portfolios plunged in value, Paulson reaped an estimated $1 billion in 2007 by correctly predicting that the housing bubble would burst, while ABN Amro, the parent holding company of ACA, lost $840,909,090 (Morgenson and Story 2011).

While Goldman protested that it did nothing illegal or unethical, the S.E.C. claimed that the firm withheld "material information from the investors– specifically, the hedge fund's role in selecting underlying securities" (Wharton Business School 2010). This case study will take an in depth look at the controversy and ask important questions such as:

- How justified were the S.E.C's allegations against Goldman?
- What motivated Goldman to act in the way that it did?
- What was Goldman's defense, and is it sound?
- Even if Goldman's actions could not be deemed to be in direct violation of the law, were they still unethical?
- What does this situation reflect about the culture and ethical values which dominate the market?

This case study analyzes the Goldman Sachs Abacus incident to provide perspective on the role of ethics in financial institutions. Corporations on Wall Street will always try to find ways to maximize profits, but how far are they willing to go, and what kinds of repercussions are there for the parties involved? Principally, this case study will examine the Goldman Sachs Abacus controversy from the point of view of Adam Smith and Milton Friedman's economic and moral philosophies respectively.

II. An in-depth account of the Abacus 2007-ACI controversy

Before delving into a more in-depth survey of Goldman Sachs Abacus controversy, several key terms ought to be defined and explained, including the central players involved in the Abacus deal and the types of financial instruments leveraged by Goldman.

The Central Players

- The Goldman Sachs Group, Inc. is a prominent global investment banking and securities firm. Founded in 1869, Goldman has become one of the world's most powerful and prominent investment banks. The firm has become known for its financial advisory services for its clients, proprietary trading, and private equity deals (Whalen and Bhala 2011). Their business principles are founded on integrity, honesty, creativity, and dedication to their clients[2].
- The Securities and Exchange Commission (SEC) is a federal agency that acts as the "primary enforcer of federal securities laws and regulates the securities industry", the U.S. stock exchanges and other electronic securities markets in the U.S (ibid). The mission of the SEC is to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation" (US SEC 2011). They also have the authority to bring civil enforcement against individuals and companies for violation of the securities laws (ibid).
- Paulson & Company is a New York based hedge fund founded in July 1994 by John A. Paulson. The hedge fund invests in the public equity markets across the globe and employs merger arbitrage, long/short, and event-driven strategies to make its investments (Bloomberg Business Week 2011).
- ACA Management is a manager of collateralized debt obligations (CDOs) in the financial markets. Its parent company is ACA Capital, a monoline bond insurance company, was founded in 1997. ACA was chosen as the portfolio selection agent by Goldman for the 2007 Abacus deal (Whalen and Bhala 2011).
- IKB Deutsche Industriebank AG (IKB) is a bank formed in 1924 and based in Dusseldorf, Germany. It specializes in providing corporate financing for small and medium-sized enterprises, international enterprises, and private equity funds. IKB was a valuable client of Goldman and had invested in several of Goldman's CDOs. In August 2007, IKB had to be bailed out due to massive losses incurred during the subprime market meltdown (ibid).

The Financial Instruments

The case involves four types of securities that all played roles during the 2008 financial crisis:

- Residential Mortgage-Backed Securities (RMBS) are a type of security made up of a pool of mortgages on residential real-estate, converted into bonds that are then sold to investors (Wharton Business School 2010). Investors of RMBSs receive income from homeowners' monthly mortgage payments. These types of bonds come in a variety of grades which rank the level of risk associated with the bond. Owners of high risk RMBSs are more likely to suffer losses if homeowners fail to make payments, but they also earn a higher interest rate when homeowners pay their mortgages on time (ibid).
- A Credit-Default Swap (CDS) is a form of an insurance policy, which protects the buyer of the CDS in the case of a loan default. It is an agreement between the buyers, who desire some form of debt default protection, and sellers, who provide the buyer with a small payoff in the event of a credit default (ibid). If the loan defaults, the buyer can "swap" the defaulted loan for the face value of the loan.
- A Collateralized Debt Obligation (CDO) is a debt security collateralized by debt obligations, often including RMBS. These securities are packaged and held by a special purpose vehicle (SPV) which issues notes that

entitle their holders to payments derived from the underlying assets (Klapper et al 2009). CDOs are split into different risk classes, where the most "senior" classes, or tranches, are considered the safest. Interest and principal payments are made in order of seniority, so more junior tranches offer higher interest rates or lower prices in order to compensate for higher default risk (ibid). Essentially, a CDO is a promise to pay cash flows to their investors in order of seniority, based on how much cash the CDO collects from the pool of bonds or assets that it owns. If the cash collected by the CDO is insufficient to pay all its investors, those in the lower tranches suffer losses first.

- Synthetic CDOs (SCDOs) are similar to ordinary CDOs except that investors own CDOs on real securities instead of the real securities themselves. The CDOs in Goldman's Abacus deal owned CDSs that would "rise or fall depending on the fortunes of a specific list of RMBSs, mainly on subprime loans to homeowners" who were considered higher risk (ibid).

Early Developments

In early 2006, the housing market in the United States was booming. Investment bankers and financial scholars thought that the American economy had "entered into a new era of sustained growth" (Schrieber 2011). Because of the great success of the housing market and the opportunity it provided Wall Street companies to profit, a new index was established; the ABX mortgage securities index administered by Markit Group, a financial information services business (ibid). This index was similar to the regular stock exchange, except that it was designed to allow traders to bet on the likelihood that the housing market would go up or down. The ABX exchange acted as the main platform for speculations on the American housing market, including Goldman's synthetic CDO Abacus 2007-ACI, the financial product detailed in this case.

Near the end of 2006, Goldman's mortgage unit was unsure about which direction they thought that the U.S. housing market was going to take. But Goldman executives decided in December 2006 to take a negative stance on the mortgage market due to worries about a housing bubble, although this stance was not disclosed publicly (Morgenson and Story 2009). Even before Goldman chose an official position in regards to the housing market, the investment bank had already started to use CDOs to place bets against mortgage securities as a way to protect against a fall in housing prices. By now, virtually every trader in Goldman took short positions on the ABX index, and over the next few months, rid themselves of any subprime mortgage securities. From "December 2006 to February 2007, Goldman Sachs effectively sold of $11 billion worth of subprime and risky mortgage securities" (Schrieber 2011).

Abacus 2007-ACI

Abacus, one type of the CDOs created by Goldman in response to the housing bubble, allowed investors to bet for, or against the mortgage securities linked to the deal. John A. Paulson of the hedge fund Paulson & Company had also taken a negative position on the housing market. He had identified 123 RMBSs that the hedge fund expected to decline in value in the near future and approached Goldman Sachs to structure a synthetic CDO based on these risky securities selected by his hedge fund (ibid). The result of these negotiations was Abacus. Paulson intended to short (or bet against) the CDO, wagering that the housing prices were going to decrease, but in order to complete the transaction, Goldman and Paulson still required a party willing to 'gamble' on the 'long' (opposite) side. Goldman Sachs knew that the German bank IKB would potentially buy the exposure that Paulson was looking to short, but only if the mortgage securities were selected by a third party. Thus, Goldman and Fabrice Tourre, a vice president at Goldman and manager of the Abacus CDO, approached ACA Management LLC that their firm serve as the "Portfolio Selection Agent" for the CDO transaction sponsored by Paulson (Calamari et al 2010).

Closing the Deal

After a series of meetings which concluded in February between Goldman, ACA and Paulson & Co, an agreement was reached on 90 RMBSs to compose the Abacus CDO (ibid). However, according the the SEC report, Goldman never disclosed to ACA or the other Abacus investors that Paulson would be shorting the selected securities, and perhaps even led them to believe that Paulson actually wanted to own some of the riskiest RMBSs (Wilchins and Brettel 2010). On April 26, 2007, Goldman finalized the Abacus Deal and received $15 million in fees for arranging the transaction (Schrieber 2011). ACA also directly invested $42 million into Abacus, and was liable for another $909 million by "insuring the specific portions of the CDO that Paulson & Co bet against" (ibid). IKB also decided to invest $150 million into Abacus.

By October 24, 2007, 83% of the mortgage-based securities had been downgraded and by January 29, 2008, 99% of the entire portfolio had been downgraded and designated as virtually worthless (ibid). So as the Abacus portfolios plunged in value, Paulson reaped an estimated $1 billion in 2007 by correcting predicting that the housing bubble would burst, while ABN Amro, the parent holding company of ACA, lost $840,909,090 (Morgenson and Story 2010). IKB also lost nearly all of its $150 million investment (Wilchins and Brettel).

The SEC Complaint Against Goldman

In April 2010, ACA, through the SEC, filed a civil lawsuit against Goldman Sachs and Fabrice Tourre, a vice president at Goldman who aided in the creation and distribution of the investment, claiming that the bank created and sold a mortgage investment that was "secretly intended to fail" (Morgenson and Story 2010). The SEC claimed that Goldman made "materially misleading statements and omissions in connection with a synthetic CDO which Goldman structured and marketed to investors" (Calamari et al 2010). The synthetic CDO in question, Abacus 2007-ACI, constructed and marketed by Goldman in early 2007, was tied to the performance of subprime RMBSs when the U.S. housing market was beginning to show several signs of early distress. The SEC claimed that synthetic CDOs such as Abacus "contributed to the recent financial crisis by magnifying losses associated with the downturn in the United States housing market" (ibid).

The SEC claimed that Goldman misled investors by representing that ACA selected the portfolio without disclosing Paulson's major role in determining the RMBSs to be included in the portfolio. For example, a flip book created by Goldman for Abacus represented on its cover page that the portfolio had been "Selected by ACA Management, LLC" (ibid), but contained no mention of Paulson and his role in the selection process.

Additionally, the SEC accused Goldman of deceiving ACA into believing that Paulson was investing in the "equity of ABACUS 2007-ACI, and therefore shared a long interest with CDO investors" (ibid). They asserted that had ACA been aware of Paulson's short position against the CDO, they would have been reluctant to allow Paulson to have such an influential role in the selection of the portfolio, or may not have decided to play a role in Abacus at all.

The official claims filed by the SEC against Goldman were that Goldman Sachs:

(a) employed devices, schemes or artifices to defraud; (b) obtained money or property by means of untrue statements of material facts or omissions of material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or (c) engaged in transactions, practices or courses of business which operated or would operate as a fraud or deceit upon purchasers of securities (ibid).

Goldman's Defense

In response to the SEC lawsuit, Goldman submitted two main documents in their defense. In these documents, Goldman insisted that the proposed recommendation by the SEC that an enforcement action be brought against Goldman is completely unwarranted (Klapper et al 2009). As with all synthetic CDOs, by definition, parties must take both long and short positions. Without a party to assume the other side of the CDO, there could be no CDO at all. The fact that some of the participants lost while the others gained was an inevitable outcome, recognized by all individuals involved. Goldman asserted that the contention that they 'tricked' their clients into purchasing an investment 'designed to fail' was ludicrous as "all participants were highly sophisticated institutions that were knowledgeable about subprime securitization products and had both the resources and the expertise to perform due diligence… and analyze the portfolio" (ibid).

Furthermore, Goldman claimed that they made all information regarding Abacus available, and that it was accurately disclosed. In their documents regarding the CDO, in which they were accused of misleading investors into believing that ACA was the only Portfolio Selection Agent, Goldman asserted that, despite Paulson's initial participation, ACA was ultimately the party who made the final call on which RMBSs would be included in the portfolio (ibid). Goldman insisted that "ACA plainly exercised its own judgment in deciding which securities were included (whatever its impression as to the economic interests of Paulson), rejected dozens that it disliked, and was entirely satisfied with the resulting portfolio" (ibid).

Additionally, Goldman reported that there was no evidence that could suggest that the portfolio would have performed any differently or that the economic outcome of the participants would have changed "had Paulson's role and interest been more transparent" (ibid). "In the end, every portfolio of lower-rated subprime RMBS" including Abacus was decimated in the market meltdown, "and any marginal differences in bond quality underlying the Staff's theory would not have resulted in any materially different outcome" (ibid).

Finally, Goldman clarified to the SEC that, as a broker-dealer acting "as an intermediary on behalf of a client, [they] had a duty to keep information concerning its client's (Paulson's) trades, positions and trading strategies confidential"(ibid). They had absolutely no duty to disclose Paulson's involvement in the process by which ACA selected the portfolio.

The Final Outcome

In July 2010, the Abacus controversy came to a somewhat unsatisfying close. Goldman was handed a fine of $550 million by the SEC and a warning that "half truths and deception" would not be tolerated (Treanor 2010). Despite accepting the fine, Goldman made it clear that they did not admit to the damaging allegations and in a public statement stated that "Goldman will not admit wrongdoing, though it will admit that its marketing materials for the investment contained incomplete information" (ibid). Although Goldman would not have included Paulson's position on the SCDO, as they claim that they were obliged to keep their clients position confidential, they stated that they could have told investors the role that the hedge fund manager played in the initial selection of the RMBSs, which were subsequently screened by ACA to be included in Abacus. By informing IKB and ACA of Paulson's involvement, Goldman would have made Paulson's role more transparent. However, Goldman stated that they should have done so not because it was unlawful to do otherwise, but because it would have reflected higher business standards. Of the $550 million paid out by Goldman, $250 million was paid to investors who lost out from the Abacus deal while the remainder went to the US Treasury (ibid).

While Goldman Sachs settled their lawsuit with ACA and the SEC, Fabrice Tourre still stands accused of deceiving investors and as of January 2011, the case concerning the now on-leave of absence Goldman Junior Vice President remains unresolved.

Questions Still Left Unanswered

Though Goldman has paid their fines and the Abacus deal has long been terminated, there are still several important questions which remain to be answered. For example, to what extent did Goldman have the responsibility to disclose certain information regarding Paulson's involvement in the Portfolio selection? If they just mentioned his name in the flip-book, would that have been adequate or should they have notified every investor of Paulson's short position? Some may ask what purpose do derivatives such as synthetic CDOs serve? Do they just turn the markets into a betting game, giving way to instability and exploitation, or do they provide a financial advantage? Goldman's actions fall into yet another grey zone when it comes to dealing with the markets. Though it seems Goldman did not outrightly commit fraud, it does appear that they put their own interests ahead of the interests of their clients. For a company that has made its reputation as a "trusted advisor and superb investment manager" (Wharton Business School 2010), such actions call into question the legitimacy of the firm.

To better evaluate the ethical dilemma presented above, the rest of this paper will delve into a moral analysis of the issue from two philosophical perspectives. First from the point of view of the father of modern economics, Adam Smith, and the second from the perspective of the Nobel Prize economist Milton Friedman.

III. Adam Smith's moral and economic philosophy

The study of economics has been linked to philosophy since the Ancient Greeks. Aristotle (384-322 BCE) wrote about several economic issues such as the allocation of scarce resources, exchange transactions and private vs. public property rights, but studied them only as moral issues (Younkins 2005). However, the study of modern economics did not truly begin until the 18th century with the writings of Richard Cantillion, an Irish economist, David Hume, a Scottish philosopher and Adam Smith, philosopher and pioneer of political economy (Hausman 1984). These thinkers began to recognize the economy as a largely self-regulating system. In particular, they recognized that there was the existence of economic "mechanisms whereby individual actions would have systematic consequences without any need for government control of the processes" (ibid).

The 21st century economic landscape is a reflection of the philosophy and ideas set forth by Smith and his contemporaries. Among Adam Smith's works, two stand out as his most influential; the *Theory of Moral Sentiments* published in 1759 and *Wealth of Nations* published in 1776 (ibid). The *Wealth of Nations*, in part records what Smith considered to be the benefits and potential problems of a market economy, and lays the foundations of the modern economic system. What many consider to be his most important contribution to economics is his theory of the "invisible hand", which recognizes the benefits that can be derived from allowing people to follow their self-interest (Smith, 1776). He analyzed the way in which a market system could combine the freedom of individuals to pursue their own objectives "with the extensive cooperation and collaboration needed in the economic field to produce our human needs" (ibid).

Adam Smith's economic theory claims that when individuals are granted the "natural liberty" to pursue their own interests, they also end up promoting the interests of the greater good (Bruni and Sugden 2008). His famous theory of the 'Invisible Hand' states that if consumers are given the opportunity to freely choose what to buy, and producers are allowed to freely choose what to produce and sell, the market will settle on a "product distribution, and prices that are beneficial to all the individual members of a community, and hence to the community as a whole" (Keller 2007). This "invisible hand", or the market, consists of self-interested suppliers on one side and self-interested buyers on the other. It is each parties self-love which Smith considered to be the best motivator for fair pricing and quality production in the markets (Smith 1776). The harmony of these individual pursuits which "often produce social and economic good" creates a "self-constraining system" (Werhane 2006). Thus, the "invisible hand" which governs market transactions, functions as a regulator of self-interests, and simultaneously promotes economic growth and well-being. In the *Wealth of Nations,* Smith gives several examples of how this mechanism works, and how it gives rise to the division of labour. He states that "it is by treaty, by barter, and by purchase, that we obtain from one another the greater part of those mutual good offices which we stand in need of" (Smith 1776). For e example, "in a tribe of hunters of shepherd, a particular person makes bows and arrows… with more readiness and dexterity than any other. He frequently exchanges them for cattle… with his companions; and he finds…in this manner he can get more cattle than if he himself went to the field to catch them" (ibid). And so this same situation happens for those who excel in other ways, and eventually, each man applies himself to a particular occupation, allowing the entire community to gain their needs in the most efficient manner (ibid).

What was revolutionary about Smith's economics was the recognition that it was not profit by itself that insured the growth and prosperity of a nation, but "the return of revenue, earned by the sale of goods that are produced by productive labor (in the form of wages, rent, and profit) to its use as capital" (Keller 2007). The wage earners will return their portion of revenue to capital by consuming goods that are produced by other productive workers. Hence, Smith was one of the first to recognize that productive labour led to the most productive society.

Although Smith provided the intellectual foundation for capitalism and praised the 'free market' for its ability to foster the most efficient economic transactions, he was not ignorant of its faults. Smith's economic theory is often taught in foundational economics classes in isolation to his moral theory. The *Theory of Moral Sentiments* is in fact the moral system which provides the general framework for his economic domain (Younkins 2011). What has been lost from Adam Smith to the neoclassical economists (although his ideas and theirs at first glance seem quite similar) is the basis of morality and control that he envisioned would go hand-in-hand with the markets (Keller 2007). Smith clearly states in the *Wealth of Nations* that the goal of an economy must be the greater economic welfare of the society. So although it was Smith's "invisible hand" which lay the foundation for the neoclassical economic ideology, Smith did not consider the act of maximizing profits themselves to be the driving ethic of businesses. Smith admits that the desire for profit is often what motivates individuals to act in certain ways, and that acting in this manner typically benefits society, but this self-interested motivation it is not moral in itself. Although Smith praised the many advantages of a capitalist economy, he was equally wary of the potential dangers it could bring. For example, in *The Wealth of Nations,* Smith describes a scenario in which landlords, free from all governmental regulations, will continue to increase rent prices to reap as much profit as they are able to before driving away their residents (Smith 1776). Another scenario described by Smith is of an employer who, when given too much power, abuses his workers with unfair wages, and since the employees must find work to provide for their families, they have no choice but to comply. Some of Smith's concerns ring true today, and he makes it clear that as beneficial as "profit maximization" can be, it is not perfect (ibid). But at the same time, Smith is wary and distrustful of too much government intervention, so how can one moderate the free markets without using too much regulation? To answer this question, Smith proposes a theory of ethics based on human happiness.

The basic premise to this theory of ethics presented in the *Theory of Moral Sentiments* is that people behave well because of a sense of empathy. Although people are motivated by self-interest to pursue wealth and welfare, we each have feelings of empathy for our fellow human beings. The hope to increase one's personal welfare can be just as strong as the hope for an increase in societal welfare. Smith explains that God has endowed man with principles of nature that interest him in the welfare of others and that make their happiness necessary to him (Younkins 2011). However, the limitation of this approach to morality is that as an individual is further removed from the object of his potential empathy, the less likely he is to be empathetic. Smith stated that "a man would ultimately have more distress over the loss of a finger than hearing the loss of millions of lives in some distant land" (Smith 1759). Smith allows self-interested action as a motive that can lead to moral behaviour, but doing good and just acts for self-interested motives is never as moral as the same acts done selflessly. He asserts that,

[The] disposition to admire, and almost worship, the rich and the powerful, and to despise, or, at least, to neglect, persons of poor and mean condition, though necessary both to establish and to maintain the distinction of ranks and the order of society, is, at the same time, the great and most universal cause of the corruption of our moral sentiments (ibid)

That individuals are often caught between their own self-interests and empathy for others is part of human nature for Smith. This is why he advocates that the model of self-interest is a model for economic behaviour that needs the foundation of a society of otherwise ethical people (Jennings 2004). Human actions are driven by a combination of self-interest and empathy; our natural desire to cooperate "motivates us to work together by dividing and specializing our labour" (Werhane 2006). In addition, this desire motivates us to barter in order to achieve "mutual and reciprocal gains" (Smith 1759). Smith asserts that whether cooperative ventures arise out of selfish interests or social passions cannot be determined; it is "both natural and an advantage to cooperate in economic affairs" (Werhane 2006).

There are two crucial points about self interest in Smith's writings. First, the pursuit of self interest is bound by the laws of justice. In the *Wealth of Nations*, he states that "Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any man, or order of men" (Smith 1759). Second, there is a sharp distinction between selfishness and self interest (James and Rassekh 2000). Smith used selfishness "in a pejorative sense for such self love as issues in harm or neglect of other people" (ibid). Self interest on the other hand embodies an 'other-regarding' aspect that requires individuals to moderate their actions. For Smith then, the overriding virtue in governing individual action then is justice, not self-love (ibid).

The current capitalist system is much more complex than it was in Smith's day, however his principles of economics and moral philosophy still apply to the exchanges and interactions that take place in the markets. The desire to increase one's profits is natural and economically beneficial, but there is a limit to how far an individual can pursue these selfish desires. Smith asserts that pursuing self-interest must be balanced with the desire to promote public interests. Economic actors certainly do not always act in a prudent, fair or cooperative manner, however, the markets work most efficiently and competitively "when prudent parsimonious actors act fairly in competitive and cooperative ventures, whether or not they deliberately intend to do so" (Werhane 2006).

IV. Milton Friedman's economic and ethical ideology

Born in 1912 in Brooklyn, N.Y., Milton Friedman was an economist, statistician and academic who was greatly influential in popularizing the virtues of a free market economic system. He won the Nobel Memorial Prize in Economics in 1976 for his "achievements in the fields of consumption analysis, monetary history and theory and for his demonstration of the complexity of stabilization policy" (Nobel Prize 2011) and was described as "the most influential economist of … the 20th century" by *The Economist* (ibid). Friedman brought about considerable changes in the way the public thought about economic questions. Most importantly to this discussion was the idea was that without economic freedom (or, without capitalism), there can be no political freedom (Friedman 1962). This was the major thesis of his book *Capitalism and Freedom*, published in 1962, in which Friedman noted that,

Historical evidence speaks with a single voice on the relation between political freedom and a free market. I know of no example in time or place of a society that has been marked by a large measure of political freedom that has not also used something comparable to a free market to organize the bulk of economic activity (ibid).

In other words, there is no real political freedom without economic freedom. The two go hand in hand. If we are not free to spend as we want, invest as we want, and choose the profession we want, then in what sense can we really be considered free? One example Friedman provides to affirm the necessary role of the markets in preserving political freedom was McCarthyism in the United States. He states that,

Entirely aside from the substantive issues involved, and the merits of the charges made, what protection did individuals, and in particular government employees, have against irresponsible accusations and probings into matters that it went against their conscience to reveal? Their appeal to the Fifth Amendment would have been a hollow mockery without an alternative to government employment.Their fundamental protection was the existence of a private-market economy in which they could earn a living. Here again, the protection was not absolute. Many potential private employers were, rightly or wrongly, averse to hiring those pilloried. It may well be that there was far less justification for the costs imposed on many of the people involved than for the costs generally imposed on people who advocate unpopular causes. But the important point is that the costs were limited and not prohibitive, as they would have been if government employment had been the only possibility (ibid).

The minor thesis of Friedman's publication was that the scope of government must be limited. He insisted that its major functions are mainly to "protect our freedom, preserve law and order, enforce contracts, and foster competitive markets" (ibid). He insists that in countries where the government installs uniform standards, progress is replaced by stagnation, and would "substitute uniform mediocrity for the variety essential for experimentation which can bring new discovery and progress" (ibid). Every great human advancement in science, literature, art, exploration, etc, has been the product of individual genius, not a result of governmental directives.

Milton Friedman was greatly influenced by the ideas of Adam Smith, and claimed that Smith' greatest insight was that both parties to an exchange can benefit so long as cooperation is strictly voluntary (Friedman 1970). External force, coercion, and/or violation of freedom are unnecessary to produce cooperation among individuals; an exceedingly simple, yet often overlooked idea. Most economic fallacies derive from the neglect of this simple insight. There exists the tendency to falsely assume that engaging in market transactions is a zero-sum gain, where one party can gain only at the expense of another. Though Friedman's ideas about the free market system are markedly similar to those held by Smith, their ideologies differ on the subject of morality in the markets. Friedman firmly believed that unfettered markets with minimal government influence provide the foundation for a free, and therefore, moral society. Capitalism, more than any other economic system, permits the exercise of individual free will, and this creates an environment in which people can freely choose to act in accordance with their moral obligations. As for the moral responsibility of corporations, Friedman stated that the "only social responsibility of a corporation is to increase its profits" (ibid). The fundamental role of the corporation in society is to "produce goods and services to satisfy the demands of the public", and they carry out this role best when they direct their attention to maximizing their profits, a direct measure of whether they are serving the needs of consumers (ibid). A corporation still is required to stay within the law and "appropriate ethical standards" when pursuing profits, but the 'morality' of their actions is determined only by how successful they are in maximizing profits, which directly benefits their shareholders, the only party they are directly accountable to (Johnson, 2001).

In *Capitalism and Freedom*, Friedman focuses primarily on the reasons why societies generally can benefit from having more freedom from government in the economic sphere. His arguments for his thesis do not stem from philosophy, but economics. He discusses several examples which have demonstrated the detrimental effects of improper government regulation in fiscal matters (by comparing economically free nations with those that are oppressed) (Friedman, 1962). Friedman even makes the claim that by adopting increasingly lassiez-faire economic systems, nations can improve their education, reduce poverty and discourage racial/religious/gender etc. discrimination (ibid). There is an economic incentive in a free market to separate economic efficiency from other characteristics of the individual. A businessman or an entrepreneur who expresses preferences in his business activities that are not related to productive efficiency is at a disadvantage compared to other individuals who do not. Such an individual is in effect imposing higher costs on himself than are other individuals who do not have such preferences. Hence, in a free market they will tend to drive him out. The free markets are the basis for how humans have overcome the past evils of feudalism and slavery, and what can protect us from "evils" such as communism and socialism. For Friedman, the advent of capitalism is considered to be the foundation of all our political (and economic) freedoms. His ethic for economics is that of profit maximization, which is best achieved through economic freedom (Keller, 2007). Friedman's entire moral philosophy is based on freedom; whatever system promotes the greatest amount of freedom is the most moral system. With economic freedom often comes political freedom.

Markets secure political freedom because they remove "the organization of economic activity from the control of political authority" (Friedman, 1962) and thus, the market eliminates this source of coercive power. Economic strength acts as a check on political power. Thus, according to one reading of Friedman's work by James and Rassekh, Friedman's virtue for governing individual action is non-coercion, in contrast to Smith's, which was justice (James and Rassekh 2000). It is important to also point out that Friedman's ethic of non-coercion not only referred to limited government intervention, but also required that individuals have an ethical obligation to conduct their actions without coercion. The principle of freedom implies that if business owners want profits, they are entitled to earn them. The pursuit of profit is entirely ethical so long as business owners do not engage in coercive (i.e. illegal, deceptive or fraudulent) practices (ibid). The "business of business is business" Friedman once stated, and corporations have an exclusive obligation, called fiduciary duty, to create wealth for their shareholders (Friedman, 1962).

The model of self-interest for Friedman is the only moral model for the markets, whereas for Smith, it is a model for economic behaviour that needs the foundation of a society of otherwise ethical people (Keller 2007). Despite all the wondrous benefits professed by Friedman of a completely unregulated market system, it is not too difficult to see how businesses and individuals often falls into moral dilemmas. Smith recognized these dangers, and that is why in the Theory of Moral Sentiments, he was so persistent to make it clear that something more must drive our actions than just self-interest. Given Smiths' great influence on Friedman, neoclassical economic theory and the modern market system, it is striking how few of his ethical views have actually made it into current discussions of economics.

Both Smith and Friedman's economic systems have been greatly influential on how modern market economies function. However, it is Friedman's 'self-interested' moral ethic that seems to have dominated the marketplace today. Is this why there have been so many instances of immoral action by individuals and corporations alike in business? Although Friedman condemned illegal and deceptive business practices, he did not present concrete ethical standards which businesses should follow beyond that which promotes freedom and serves the interests of the shareholders. Cases such as the Enron scandal are clear indicators of the damage that can be done when corporations act immorally. It is obvious that Enron's action were obviously immoral because they were illegal. Clearly, both Friedman and Smith would have condemned such actions. But what about scenarios where the line is not drawn quite as clear? How can we evaluate the actions of an individual or a corporation as ethical or unethical?

This seems to depend both on which moral philosophy one would use in their evaluation.

V. Case analysis from the point of view of Smith

The Goldman fraud case can be simplified into three basic questions and their answers:

1. Did Goldman represent to IKB and the other long parties that Abacus was assembled by an independent and uninterested 3rd party?
2. Did Paulson have a influence or control over the assembly of Abacus?
3. Did Goldman know the answers to questions 1 and 2 at the time it sold Abacus?

If the answer is yes to questions 1 and 2, Goldman would have committed civil fraud. If the answer is yes to all three questions, Goldman would have committed criminal fraud. Either way, it is obvious that Adam Smith would have condemned Goldman's actions. If Goldman executives and others have acted illegally, they should, everyone can agree, should be punished in law (Watt 2010). But did hedge fund Paulson & Co in fact choose the residential mortgage securities held within Abacus, or was it independent firm ACA Management that had the final say? What if Paulson gave a list of securities that it wanted in the deal, and Abacus chose some of them but no securities outside the list? That's one for the legal experts and the SEC to scrutinize and examine. Fortunately for Goldman, there is insufficient proof to demonstrate that the company did indeed misrepresent to their long clients or ACA that Paulson was taking a long position on Abacus, in contrast to the his actual short position.

However, since Goldman settled the case without going to court, their actions were never officially labelled 'illegal'. Thus, the answer to the previous three questions were never determined, and if they can be, that is a topic left for the policy makers and lawyers, whereas we are more interested in the ethicality, not legality, of the issues at hand. This is what the Abacus CDO controversy such an interesting ethical dilemma. Ethical issues, as opposed to the deterrence or punishment of unethical conduct, are debates about moral uncertainties. These uncertainties may be about consequences (i.e. will an action product a good or bad result?) or about intentions (what result does the party wish to achieve?). Often they involve efforts to choose between competing positions; in the Abacus case, should Goldman arrange a securities investment to specifically cater to the wishes of a prominent client, Paulson, or should they create a portfolio which provides a 'level playing field' for all parties involved?

One thing can be said for sure, Goldman and Fabrice Tourre did not fully disclose to ACA, IKB, or any of the other clients involved, the role that Paulson played in the selection of the Abacus portfolio. Despite Goldman's negative outlook on the housing market, they were still willing to sell to their clients the opposite position on a portfolio which was primarily selected by an individual, namely Paulson, who believed that it would fail. The motive? Profits. Although Smith encourages the individual pursuit of wealth, it was his intention that these desires not overrun human compassion and sympathy. That the company allowed, and led, their clients to invest in a portfolio which they personally took a bearish stance, and did not openly share this information with their clients is the primary reason Smith would not have condoned the manner in which Goldman created and marketed Abacus 2007-ACI. In the *Wealth of Nations* Smith writes that:

Though the principles of the banking trade may appear somewhat abstruse, the practice is capable of being reduced to strict rules. To depart upon any occasion from those rules, in consequence of some flattering speculation of extraordinary gain, is almost always extremely dangerous, and frequently fatal to the banking company which attempts it. (Smith 1776)

It was Smith's intention that the economy and the corporations in it would work for the public good, and not just for the benefit of the few elite. Smith considered the banking industry to play a key role in facilitating the process of economic development. By enabling a degree of "fiduciary substitution, the banking system had facilitated an expansion of the 'stock' that could be employed for productive purposes" (Farrant 1996). He saw the banking system as a type of mechanism which allowed the decisions made by some individuals to save their money to be translated into decisions made by others to utilize the saved resources for investment purposes (ibid). Thus, according to Smith, the money placed in trust by Paulson, ACA, and IKB to Goldman Sachs was to be invested to produce further benefits for all parties involved. However, the only beneficiary of the Abacus investment was Paulson. The issue of which party picked which RMBSs to be included in the portfolio pales in comparison to the fact that Goldman, and investment bank, allowed some of their clients to suffer severe losses due despite their personal views that the housing market was likely doomed to fail. Of course, there was no way any party could have known for sure whether the housing bubble would burst, however Goldman's own analysis seemed to imply that the failure of the housing market would occur. Had they made this analysis known to IKB and ACA, these investors may have been less bullish on the Abacus portfolio.

Goldman Sachs has often claimed in their business principles that their "clients interests always come first" (Goldman Sachs 2011), a commendable principle to hold. However their actions in the Abacus case do not reflect this standard. When the SEC said that Goldman has a duty to serve clients in its role as a "market maker by providing liquidity", Mr. Tourre responded he did "not believe [that] we (Goldman Sachs) act as an investment advisor to our clients" (Arends 2010). Although Smith would have hoped that such institutions would follow through with their business principles, he also warned clients to be wary and to complete their due diligence before entrusting funds to a third party. He wrote that,

Being the managers rather of other people's money than of their own, it cannot be well expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. (Smith 1776)

Yes, Goldman should have been upfront about their analysis of the housing market, but ACA and IKB also should have been more vigilant in regards to their investment decision. These companies had equal access to all the information about the RMBSs chosen for the portfolio, research about the current housing situation, and the resources to come to their own conclusion about the success, or failure, of the Abacus portfolio. ACA especially, as the primary selection agent for the Abacus portfolio, should have been able establish for themselves the quality of the investments chosen for Abacus. Even if ACA and IKB had been aware of Paulson's short position on the fund, it is unlikely that they would have changed their opinion that Abacus was going to succeed. Especially since, at the start of the investment, Paulson was a relatively unknown investor, so these well established corporations would not have changed their analysis of the investment based on this one man's prediction. IKB and ACA knew the composition of the reference portfolio, the structure of the transaction, they had the ability and the experience to analyze the deal, but simply came to the wrong conclusion. If the deal had gone in the opposite direction, which, at the beginning, was a possible scenario, there would be no complaint filed against Goldman for withholding the information about Paulson and their own analysis of the housing market.

All parties involved, IKB, ACA, Goldman, and Paulson, participated in the deal to make profits. Their actions all stemmed from the same motive: to pursue wealth. Each participant had different opinions regarding the final outcome of the Abacus SCDO, and all knew that either the long or short position would eventually fail. If Goldman provided full disclosure of their personal opinions regarding the portfolio and of Paulson's position, the outcomes are unlikely to have changed. However, Smith is less concerned with the final results than the motive and spirit behind the actions. The SEC allegations suggest that Goldman has at least broken the spirit of what investment banking is supposed to be, even if they had not broken the law. For Smith, the forces of the free-market were supposed to "narrow profit margins, not magnify them, creating an economic environment where no one was too big to fail because no one could afford to make a serious mistake" (Rollert 2010). In his opinion, it is better for all parties to receive a smaller profit, than for a single individual to walk away with a massive profit, as Paulson did through the Abacus deal. Smith endorsed the economics of a free market, but he was wary of the moral consequences of capitalism. In the *Wealth of Nations,* Smith praised small business owners (the butcher, the brewer, and the baker, the tradesmen and shopkeepers) who exemplified the prudence, industry, and thrift valorized in his text. In contrast, he was suspicious of the success of the more "cosmopolitan merchants". Their "high rate of profit" betokened trade restrictions and royal monopolies and tended to "destroy that parsimony which in other circumstances is natural to the character of the merchant" (Smith 1776), fostering "decadence and desuetude among the members of that class" (Rollert 2010). The Abacus case is one such situation where the parties acting on self-interested motives did not result in a generally positive outcome. The scenario created by Goldman set up exactly the opposite: a zero-sum game, in which one player's loss is the other player's gain. However, it is unlikely that Smith would have blamed this outcome on Goldman Sachs, but rather on the structure of the security itself.

Smith did not imagine, nor would he have endorsed, the increased emphasis of banks on so-called "off-balance-sheet activities", such as financial derivatives trading and investment banking services (Bholat 2010). The ABX mortgage securities index and the financial instruments utilized in the Abacus SCDO deal would have greatly concerned Smith. In book 4 of the *Wealth of Nations*, Smith defends two speculative activities, forestalling and engrossing (Smith 1776). These two practices were very common in the eighteenth-century corn trade. For example, forestallers acquired corn at low prices to resell at times of scarcity while engrosses "profited from geographic differences in corn prices" (Bholat 2010). These arbitrage activities were highly criticized by the general public, as many believed forestalling and engrossing to simply raise prices of corn. However, Smith argued that these speculative activities were in fact beneficial practices. If speculators predicted scarcity but their prediction was wrong, they lost money. The risk was placed solely on the specialists, not on the consumers. The speculators then not only had to sell the corn at a loss, but also pay its storage and/or transportation costs (ibid). However, when the scarcity was real, Smith explained that "the best thing that can be done for the people is to divide the inconveniences of it as equally as possible through all the different months, and weeks, and days of the year" and, of course, across the nation (Smith 1776). How do these speculative activities of 18th century England differ from the types of practices such as CDSs and CDOs that are widespread today? The speculators of Smith's era took ownership of a tangible commodity, but today, investors cannot physically own what they are trading. For example CDSs, mentioned earlier, are financial agreements in which one contracting party makes payments to the other for a payout should the underlying asset default. However, neither party need to actually own the underlying asset. These sorts of speculative bets on money, for money, "would surely be repugnant for Smith" (Bholat 2010). Smith often referred to money as "dead stock" in his work, claiming that it "makes no part of the revenue of the society to which it belongs"(Smith 1776). For these reasons, Smith preferred a properly regulated paper currency to a metallic one. By such a substitution, a society could transfer its labor resources away from the mining of dead stock and "convert, as it were, a great part of its highways into good pastures and corn fields, and thereby increase very considerably the annual produce of its land and labour" (ibid). The purpose of money is to contribute and develop physical, tangible goods, in the words of Adam Smith, "the sole use of money is to circulate consumable goods" and "money is neither a material to work upon, nor a tool to work with" (ibid).

However, times have changed, and it is unproductive to propose returning to the fiscal system of the 18th century. It is impossible to ban financial derivatives and eliminate speculation on intangibles. However, Smith would suggest that these types of mortgage-backed securities could be more carefully regulated. It is a commonly held misconception that Smith rejected all forms of government regulation. In fact, Smith believed that the freedom of the market works best when protected by the laws of justice, and when its "participants exercise a high degree of prudence in their conduct" (Krugman 2010). Smith recognized the appeal to engage in financial transactions such as Abacus. The prospect of potentially reaping massive earnings is tantalizing, so when corporations or individuals engage in such transactions, they are not necessarily acting immorally, they are simply following their human instincts. Because Smith recognized that humans act in a certain, self-interested, manner, regulations and government restrictions play a necessary role in the moderation of the markets. Regulations are "a manifest violation of that natural liberty which it is the proper business of law, not to infringe but to accept", but set against the "security of the whole society" the "natural liberty of a few individuals" which "might endanger" that "security", should and "ought to be restrained by the laws of all governments; the most free, as well as the most despotical" (Krugman 2010). Such regulations would be instated only as a necessary means to ensure that when corporations and businesses pursue wealth, they do not overstep the thin line between what does and does not harm others. If IKB had individually selected the stock in which they wished to invest, and lost money, this would be considered a reasonable outcome for Smith, as the only party that was harmed was the individual investor. However, since Goldman facilitated the trade which harmed some of their clients, and potentially even predicted their clients downfall, its actions are reprehensible in the eyes of Smith.

There has already been some talk about whether there should be a financial derivatives reformation. The typical rationale given for these types of financial innovations such as CDOs and CDSs is that they "promote the efficient allocation of capital" (Kwak 2010). But when it comes to SCDOs, which are composed of zero-sum derivatives transactions, this argument does not hold water. SCDOs are over-the-counter investments, where prices are not transparent, and do not directly allocate capital. Thus, it is hard to see how SCDOs make their "underlying securities significantly more liquid" (ibid). Although the benefits of SCDOs are difficult to determine, their costs are easy to discern. Most conspicuously, they "magnify economic risks by amplifying shocks to the financial system in unpredictable ways" (ibid). The US democrats, who are pushing for financial reform legislation will likely consider SCDOs and how they ought to be regulated, or even banned, a move that Smith would likely approve of, although somewhat reluctantly.

The ethical analysis of the Goldman Sachs Abacus 2007-ACI CDO case from the viewpoint of Smith is certainly a dire one. Based on Smith's moral and economic principles, none of the parties involved acted in a manner that the great philosopher would have condoned. In fact, even the investment itself would have been seen as both ethically and economically unstable. According to Smith, although Goldman Sachs is encouraged to pursue their own profits, as an investment bank, these profits should not come at the expense of their clients. That being said, in setting up the Abacus deal, one set of clients was bound to fail no matter what results came to fruition. Such investment deals is what would have greatly troubled Adam Smith; the notion that there are investment instruments which intentionally create a situation in which certain people will detriment goes against the very core principles of his economic ideology. The purpose of the economic system is to benefit as many individuals a possible, not to raise a few 'clever' or 'crafty' specialists up onto a pedestal. The concerns of the SEC are only scratch the surface of what would have troubled Smith. Goldman's lack of transparency throughout the deal created a circumstance where each participant had to act as though they were players in a strategic, cutthroat 'game', engaging in a calculated rivalry dominated by the clever and powerful. This situation is a far cry from the "honest barters" that Smith envisioned would take place in an ideal marketplace (Smith 1776). Moreover, Smith would have accurately predicted that, if Goldman had prescribed to a higher ethical standard, the benefits would far outweigh the small profit gained by orchestrating the deal for Paulson. Once the SEC lawsuit was filed, the 'bad press' about Goldman that flooded the internet and newspapers highly damaged the bank's reputation. Their stock share price plummeted the day the SEC announced the lawsuit, and the $550 million fine paid to settle the case far outweighed the paltry commission received for constructing and marketing the SCDO.

VI. Case analysis from the point of view of Friedman

As one can imagine, Nobel Prize winning economist Milton Friedman would have had quite a different opinion regarding Goldman Sachs Abacus case than Adam Smith. In his famous essay, *The Social Responsibility of Business is to Increase its Profits,* Friedman argued that "people responsible for decisions and action in business should not exercise social responsibility in their capacity as company executives. Instead, they should concentrate on increasing the profits of their companies" (Mulligan 1986). In isolation, this statement seems to imply that Friedman would approve of any method that can be utilized by businessmen and women to increase their profits. The most popular and common reading of Friedman that is that his "analysis minimizes any moral duties beyond following the law, and thus, supports a weak version of business ethics" (Cosans 2009). However, in an interview with the Chairman of the Washington Capital Research Centre, Friedman states that there is "a very real social responsibility" for corporations (Johnson 2001). Although he maintained that the greatest social responsibility of a business is to "make as much money as possible", they still are subject to staying not only within the law, but also within the "appropriate ethical standard" of society (ibid). Thus, when analyzing the Goldman Sachs case, Friedman would not only consider whether or not the investment bank broke particular laws, but also whether or not it jeopardized the ethical standards of society. What these ethical standards might be will be discussed during this analysis.

Friedman was a strong advocate of the capitalist system. He praised and encouraged corporations and businesses to be as creative and entrepreneurial as possible in order to create success for themselves and for their shareholders. Unlike Adam Smith, Friedman would not have severely criticized financial derivatives such as CDOs and CDSs, which are created and utilized for profit maximization. Such financial instruments, Friedman would argue, are tools which can benefit those who are able to understand and properly utilize them. But did Goldman use these financial derivates in such a way that conforms to societal ethical standards? In this disquisition, it will be assumed, as was done during the analysis from the perspective of Smith, that Goldman did not commit civil or criminal fraud.

Perhaps why there has been some confusion about exactly what Friedman considered to be appropriate moral principles for corporations to follow is that he never explicitly states what 'societal ethical standards' are. Some cultures follow a very strict moral code, while others are more lenient. For some societies, Goldman's actions harshly clash with their moral principles, as they were somewhat untruthful, selfish, and apathetic towards ACA and IKB's detriments. Others would state that Goldman was simply trying to maximize profits, that they never explicitly lied, but only concealed some minor facts, and that ACA and IKB were responsible for their own investment decisions. Indeed, Friedman's "failure to outline in detail what he sees as the core of ethical custom is perhaps the reason why some business ethicists have gone on to argue that his position is that executives should do anything that maximizes profits as long as it is legal" (Cosans 2009). If this were the position ascribed to Friedman, the Goldman case would be simple to analyze: since the corporation was acting in order to maximize profits, and did so within the boundary of the law (although perhaps pressed up very closely to that boundary), their actions are justifiable. However, at the end of his essay *The Social Responsibility of Business to Increase Its Profits*, Friedman states that businesses should engage in "open and free competitions without deception or fraud" (Friedman 1970). Profits themselves are not necessarily the ultimate end-goal of corporations, but rather it is freedom. Friedman asserts that pursuing profits facilitates and encourages freedom, because in doing so, the executives of a company act in a manner that recognizes the rights of the shareholders. According to James and Rassekh, it can thus be concluded that Friedman had a strong sense that any "business activity which adversely affects someone against their will is unethical" (James and Rassekh 2000).

Based on James and Rassekh's analysis of Friedman, ACA and IKB were certainly adversely affected by the Abacus deal constructed by Goldman, however, since they entered the investment with the knowledge that the portfolio could potentially fail, it cannot be concluded that Goldman acted unethically. In this case, Goldman's defense that "extensive disclosure was provided" is justified. As was stated in their report to the SEC:

IKB, a large German Bank and sophisticated CDO market participant and ACA Capital Management, the two investors, were provided extensive information about the underlying mortgage securities. The risk associated with the securities was known to these investors, who were among the most sophisticated mortgage investors in the world. These investors also understood that a synthetic CDO transaction necessarily included both a long and short side (Klapper et al 2009).

Friedman would have viewed such a scenario simply as a basic financial transaction taking place between several parties whose interests would obviously conflict. That ACA and IKB may not have directly known who their competitor was in this situation is not relevant to the fact that both investors knew that their position on the investment could not be guaranteed to yield the most favorable outcome. Also, as was stated during the Smith analysis, because of client confidentiality, Goldman would not have even been permitted to disclose Paulson's position to ACA and IKB.

However, where Goldman's defense begins to falter is in the fact that Paulson not only took the other side of the bet, he actively selected the reference portfolio, and Goldman is alleged to have misrepresented that fact. Obviously, sophisticated investors know that someone is 'betting' against them, the problem is that the investors in Goldman's deal reasonably thought that the Abacus portfolio had been carefully selected by a "reputable manager whose sole interest lay in optimizing the performance of the CDO" (Wharton Business School 2010). Friedman stated that although business ought to maximize profits, they must do so within the limits of the law, and without fraud or deception. Clearly, there was some level of deception on Goldman's part when it came to fully notifying their investors of Paulson's involvement of the selection of the RMBSs to be included in Abacus. Although some have argued that, had Goldman told ACA and IKB of Paulson's role, that it would have been highly unlikely that they would have changed their minds about investing in Abacus, this, according to Friedman, would not justify the omission of such a key element of information. Goldman could have easily been open to ACA and IKB about the portfolio selection process, maintaining their integrity, reputation, and even profit margin. Had they told them something along the lines that "the Abacus portfolio was selected by a prominent trader who has adopted an ultra-bearish view of the housing market. However, most analysts are predicting that the housing market is only going to plateau, not crash as Paulson seems to believe. If this unexpected outcome were to occur, these particular assets chosen for Abacus will be hit the hardest. However, very few other sophisticated and intelligent investors and financial institutions believes that such an outcome will occur. If it is the case that Paulson is wrong, which is a very likely outcome, then this portfolio will provide significant yield for minimal risk."

If this is what Goldman had done, they would have, quite ethically, simply have acted as a broker. They would still have made their commission from Paulson for arranging the deal, and would have likely been able to sell the portfolio to ACA and IKB regardless of stating this information. So why was Goldman unwilling to disclose this pertinent information to their investors? Friedman has made the observation that businessmen often end up doing things which, "while in their short-term interests, are very harmful to their business in the long run" (Johnson 2001). He would have argued that Goldman was simply looking to its short term interests, which, although is not necessarily unethical, is unwise. Enticed by the potentially huge returns of arranging the Abacus deal, they were willing to 'fudge' the facts in order to draw more cliental. Greed itself for Friedman is not unethical. In a 1979 interview with Phil Donahue, Friedman stated that the world runs on greed, that it runs on "individuals pursuing their separate endeavors" and this has resulted in the "greatest achievements of civilization" (Donahue 1979). However the manner in which Goldman executed the deal is not ideal. It can be argued that by hiding some facts, they limited the freedom of ACA and IKB to be able to make a fully informed decision regarding the investment portfolio. In two of his major books, *Capitalism and Freedom* and *Free to Choose,* Friedman consistently identifies freedom as a key social end throughout his analysis (Friedman 1962). Thus, since freedom is the most important virtue for Friedman, it is always unfavorable when it is restricted, either by the government, or by fellow businessmen. According to David Silver's analysis of Friedman's moral framework, he attributes Friedman's "abhorrence of deception and fraud to Friedman's value of freedom" (Silver 2005). He goes on to explain that "deception undercuts the autonomy of its victim because it is an instrument by which the deceiver seeks to unfairly gain control over the will of others" (ibid). So the fundamental question for Friedman that needs to be answered when analyzing the Goldman Abacus Case is: to what extent did Goldman's actions infringe upon the liberty of ACA and IKB to make an autonomous decision regarding their investment position on Abacus?

Based on the above question, I contend that Friedman would not have condemned Goldman's actions as immoral, but simply injudicious. Although there was some element of deception, which Friedman would not have supported, the information that was withheld was not of such integral importance that it hindered ACA and IKB's ability to make a well informed decision regarding their investment in Abacus. Although these two parties did not enter the agreement with perfect information, the information which they lacked did not put them in a position where they were unable to make a grounded decision. In this particular scenario, Goldman was not acting as a financial advisor, but as a 'market maker', fostering the creating of an investment deal, leaving the decision of which side to choose to its clients. True, there may have been some element of attempting to conceal Paulson's role in selecting the portfolio in order to better 'entice' ACA and IKB into entering the agreement more willingly, but upon close analysis of the information provided to ACA about Paulson and Abacus, Goldman in no way 'stripped' them of their freedom to make such an investment decision.

Reading the SEC complaint, it is clear that ACA and Paulson met face to face several times, as well as corresponded over email. Such contact was direct, not channelled through Goldman Sachs (Calamari et al 2010). They had full opportunity to directly ask Paulson about his position on the portfolio, and had Paulson declined to answer, it would have been in his full rights to do so, as one's investment position is a private matter. Also, based on their correspondence with Paulson, clearly, they recognized that he had some role to play in influencing the RMBSs chosen to be included in the Abacus portfolio, as this was the primary matter of their communication. Additionally, it was made clear that the RMBSs initially selected by Paulson were then reviewed by ACA, who had the ability to remove any RMBS which they deemed unsuitable for the portfolio (ibid). Goldman provided them with ample opportunity to freely analyze the portfolio, and alter it to better fit their investment needs and desires. IKB also had access to the same information, data, and analysis as ACA, and thus their investment decision should have been equally well informed.

For these reasons, it is my opinion that Friedman would not have deemed Goldman's actions as unethical or immoral. Their deceit was not of such magnitude that it substantially influenced ACA and IKB's decision making capabilities. However, he would contend that Goldman's actions were injudicious. The arranger and marketer of a new investment vehicle must have some fiduciary obligation to the new investors, ought to disclose any conflict of interest, and reveal information it has regarding counter-parties taking opposite views with whom the vehicle might trade. Goldman did not fulfill these obligations to their fullest capabilities, and although this did not adversely affect the investment decisions of ACA and IKB, it did damage their reputation as a corporation which always values and places their client's interests first. When their actions were exposed by the SEC, the news negatively influenced their stock price and their corporate image. Thinking in the short term, Goldman unwisely affected their long term image and profitability. Potential clients perhaps felt as though they could not place their full trust in Goldman Sachs, and this somewhat damaged Goldman's prospects for new clientele. He would have advised that in the future, complete honesty when dealing with clients leads to a better business culture, which can aid profitability by attracting and maintaining clientele.

VII. Conclusion

Contemporary issues in business ethics are often complex and require significant depth and breadth of analysis. The Goldman Sachs Abacus 2007-ACI case is a scenario which raises many questions concerning the value of financial instruments such as SCDOs to society and the duty and responsibility of a corporation to their client. It has been demonstrated that moral philosophy can significantly aid in the analysis of various ethical issues in the market, by offering a critical point of view. Although the results of an analysis will drastically vary depending on the type of philosophical analysis utilized, each analysis provides clear and distinct conclusions regarding the case in question. Smith and Friedman each have significantly different opinions regarding the morality of Goldman's actions during their creating and marketing of Abacus, but regardless of which analysis an individual prefers, each viewpoint can aid corporations in making more ethical business decisions in the future. It is the convention held by many that there is a tension between businesses pursuing profits and acting ethically. Although issues of morality do arise in the markets, such as that in the discussed Goldman case, business ethics, morality, and profits need not be so divided. In order to be successful, business professionals ought to apply ethical principles directly to their businesses. When businesses understand the value of business ethics to corporate decision making, they are more likely to be able to earn the trust of their clientele, attract new customers, assure their shareholders, and thus, increase profits.

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[2] For the complete list of Goldman Sachs’ business principles please refer to: http://www2.goldmansachs.com/our-firm/our-people/business-principles.html

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