

Ethical Challenges of Complex Products: Case of Goldman Sachs and the Synthetic Collateralized Debt Obligations

Franklin M. Lartey¹

¹Cox Communications, 6305 Peachtree Dunwoody Road, Atlanta, GA 30328, USA

Correspondence: Franklin M. Lartey, Cox Communications, 6305 Peachtree Dunwoody Road, Atlanta, GA 30328, USA.

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Abstract

In analyzing complex products, this study selected the company Goldman Sachs and one of its product offerings, the synthetic collateralized debt obligation (synthetic CDO). The study later analyzed the ethical implications of providing such a complex product to customers. A review of the literature indicates that researchers identified this product and other associated derivatives of the mortgage backed securities as the main causes of the 2008 financial crisis in the United States of America. As such, Goldman Sachs' offering of the product posed ethical and moral issues. An analysis of the company and its offering was done under the lenses of various ethical theories such as Kohlberg's theory of moral reasoning, the Kantian ethics, the utilitarian perspective, Friedman's shareholder theory, the stakeholder theory, the market approach to consumer protection, and the contract view of consumer protection. Besides Friedman's shareholder theory, all other theories judged the product offering morally wrong and unethical. At the end of the study, the author suggested a contribution to knowledge regarding Kohlberg's theory of moral reasoning in its application to organizations. The author also suggested further research to validate the outcome of Friedman's shareholder theory regarding this case.

Keywords: corporate social responsibility, collateralized debt obligation, Dodd-Frank, ethical theories, Friedman, Glass-Steagall, Gramm-Leach-Bliley, Kant, Kohlberg, shareholder, stakeholder, synthetic CDO, utilitarian

1. Introduction

In recent years, consumers have increasingly faced a variety of problems such as poorly built products, failure of companies to honor warranties, deceptive advertising and selling practices, complexity of products, and even dangerous and risky products. Yin et al. (2020) as well as Parker (2011) emphasized on the proliferation of this phenomenon in financial and investment firms. Examples of such practices include the packaging of home mortgage assets into a product called Collateralized Debt Obligations (CDO), and the creation of other derivative products such as the synthetic collateralized debt obligation. The creation of such complex products by investment firms is generally aimed at making more money to the firms first, not to the investors. As such, these product offerings suggest the existence of an ethical dilemma because firms can maximize their profits by confusing investors with products that appear attractive at first sight. The outcome of such practices can impact a region, a nation, and even the world.

In 2008, the worst economic and financial crisis since the era of the great depression hit the United States and the rest of the world (Amadeo, 2013; Kraft and Furlong, 2013). On April 27, 2010, Carl Levin, United States Senator for Michigan and Chairman of the Permanent Subcommittee on Investigations used words that clearly expressed his frustration and that of all Americans. He screamed, "You should not be selling junk, you should not be selling crap, you should not be betting against your own customers at the same time you are selling to them" (Faber, 2010). These harsh words used by Carl Levin while confronting Lloyd Blankfein, the CEO of the investment bank Goldman Sachs, summarize the case studied here. Goldman Sachs, an investment bank well known on Wall Street was being investigated for making profits at the expense of its own clients, which is considered an unethical practice. The source of this investigation was the offering of the company's Abacus 2007-AC1 product, a synthetic collateralized debt obligation.

In part due to asset-backed securities such as the collateralized debt obligation (CDOs) and other complex derivative products such as the synthetic collateralized debt obligation, the housing crisis and the financial crisis

that followed call for a detailed analysis of these products from an ethical standpoint. Pioneered by the investment firm Goldman Sachs, the synthetic collateralized debt obligation is the primary focus of this study. As such, this paper will analyze one of the products that contributed in the collapse of the housing market, the reasons for the collapse, and the decisions that accelerated the burst of the housing bubble. To narrow the scope of the work, the study will be limited to one main firm and one product: Goldman Sachs and the synthetic collateralized debt obligation (synthetic CDO). This study will also suggest possible solutions based on ethical theories that explain what happened and discuss solutions that can prevent such events from happening again.

To fulfill the goals stated above, this paper will provide a descriptive view of Goldman Sachs, followed by that of the synthetic CDO offered by this company. Understanding this derivative product will help understand the making of the financial crisis, the contribution of such product in the overall crisis, and the global impact of the decisions made. The study will finally analyze the case presented from an ethical standpoint and suggest guidelines and public policies for dealing with similar situations in the future.

2. Goldman Sachs: An Ethical Company

2.1 Presentation of Goldman Sachs

Goldman Sachs, the most successful firm in the history of Wall Street (Mogielnicki, 2011) was founded in 1869 in New York City by Marcus Goldman, a German immigrant. The company was a one-man, one-room, small commercial paper brokerage on Pine Street under the name Goldman. Its principle was straightforward: “Goldman would connect investors (often banks) and entrepreneurs, shaving off a slight profit for himself in the deal” (Beattie, 2010). The name Goldman was later changed to the current Goldman Sachs & Co in 1885 after Samuel Sachs, Goldman’s son-in-law joined the company. The company later joined the New York Stock Exchange (NYSE) in 1896 and became a major player in the initial equity sales for well-known companies such as Sears, Roebuck & Co. in 1906. When the stock market collapsed in 1929, Goldman Sachs suffered big losses driven by its investment unit, Goldman Sachs Trading Corp, which was essentially a series of highly leveraged investment trusts (The Wall Street Journal, 2010). The company was able to recover due to its core business of investment banking services along with the original commercial paper brokerage.

Goldman Sachs started to rise in power in 1956 when Sydney Weinberg, the seventh-grade-educated janitor assistant who became CEO masterminded the largest stock offering of the time with the Ford Motor Company's initial public offering (IPO). As explained by Henry (2006), Ford became a public company on Jan. 17, 1956. Its stock was offered to the public for the price of \$64.50 and it closed at \$69.50 on the first trading day. The market capitalization of the stock after the first trading day was valued at \$709 million.

2.2 An Ethically Responsible Company

Gus Levy succeeded Weinberg at the head of Goldman Sachs in 1969. He built back the company’s stock and bonds trading business and initiated a tradition of charity by inciting the employees to more philanthropic work. In the 1980s, there was a surge in company takeovers on the financial market and this was a new lucrative market for most investment banks. As confirmed by Andrei Shleifer of the Harvard University’s Department of Economics and Robert Vishny of the Graduate School of Business in the University of Chicago, “of the 1980 Fortune 500 companies, at least 143, or 28 percent, were acquired by 1989. . . . many transactions, especially the large ones, were hostile – done against the will of the target firm’s management” (Schleifer and Vishny, 1991). As a result, many takeovers failed because management did not agree with them and entire management teams left their taken companies to work for the competition. Ethically, Goldman Sachs decided not to represent any acquiring company that made hostile takeovers. From then on, the company was known as “The Wall Street White Knight; the go-to good guys who defended corporate America” (Faber, 2010).

2.3 The Repeal of the Glass-Steagall Act of 1933

In response to the financial crisis and the failure of the banks during the Great Depression, the Glass-Steagall Act of 1933 became the first bill signed by President Franklin D. Roosevelt into law after taking the oath of office. This act created a separation between commercial banking and investment banking, prohibiting any firm from doing both activities at the same time (Crawford, 2011; Rahman, 2012). In November 1999, the Glass-Steagall Act of 1933 was repealed by the signing into law of the Gramm-Leach-Bliley Act, also known as the Financial Services Modernization Act of 1999 (Cebula, 2010; Cuaresma, 2002). Now, financial structures could provide both investment and banking services.

2.4 New Services and Products

After Jon Corzine stepped aside as the firm's co-head in 1998 leaving the chief executive position to Henry Paulson, just like other investment banks, Goldman Sachs moved from classic investment banking, mergers,

financing, and client advising, towards trading for both its clients and itself. In other words, they went from advising corporations and handling their financing, to running giant hedge funds. In 2007, under the leadership of a new CEO Lloyd Blankfein who replaced Henry Paulson who became U.S. Secretary of the Treasury since July 2006, Goldman Sachs entered into a deal called ABACUS 2007-AC1 with the hedge fund manager John Paulson (unrelated to Henry Paulson), founder and president of the hedge fund Paulson & Co. In essence, ABACUS 2007-AC1 was a synthetic collateralized debt obligation (synthetic CDO).

3. A New Product: The Synthetic Collateralized Debt Obligations

A debt can also be called “debt obligation,” because the debtor has the obligation to pay the debt when it becomes due. This includes any financial promise that must be honored such as a car loan, a mortgage loan, a co-signed loan application, or borrowed cash. Simply explained, a debt obligation is just a debt.

A collateralized debt obligation (CDO) is a structured asset-backed security: it is a debt backed by collaterals made of properties or assets that are offered to secure a loan or other credit. The collateral is purchased with the money that was borrowed. There exist collateralized mortgage obligation (CMO) and collateralized bond obligation (CBO), but CDOs are unique in the sense that they contain different types of debt also called tranches or slices, and varying credit risks associated with each slice. The slices have different maturities and just like with any financial product, the higher the risk associated to a slice, the higher the possibilities of reward. The main feature of a CDO structure is the slicing of the credit risk into various tranches. As such, any loss will affect the first tranche called ‘equity’ or ‘first loss’, then the next tranche called ‘mezzanine,’ and lastly the ‘senior’ tranches. Each tranche will bear a different percentage of any gain or loss. At issuance, the tranches are rated by an independent agency such as Moody’s.

Although any type of asset can be bought for the CDO, the most commonly purchased assets are mortgage backed securities (MBS) as explained by Conerly (2010). When the underlying mortgage is paid as scheduled, the CDO would pay off. But if the mortgage is not paid, the CDO defaults and investors lose their money. As such, the incomes of investors in a CDO depend on the underlying homeowners paying their mortgages on time.

In summary, a synthetic CDO is like a CDO in terms of profits and loss but does not have any asset. It consists of credit default swaps (CDS) which are contracts between two parties, one betting that the CDO with its pool of mortgage backed securities (MBS) will pay off as scheduled, the other betting against, opting for the failure of the underlying mortgages.

4. Challenge of the New Product

The synthetic collateralized debt obligation is without a doubt an invention of Wall Street. Getting in the synthetic CDO deal was a small step for Goldman Sachs, since it was already providing mortgage backed securities (MBS) as a product to its customers. As such, the company could purchase home mortgages from lenders or banks around the country, create pools of thousands of these mortgages and sell shares of these pools as MBS, which offered a steady stream of cash flowing from the home owners’ monthly payment. Hence, it becomes easy and tempting to offer a new product or service which would simply consist of betting on whether the homeowners would continue making their payments or not.

One such gamble offered by Goldman Sachs was named ABACUS 2007-AC1. This was a special purpose entity (SPE) legally registered in the Cayman Islands. The capital strategy of this SPE was the financial guaranty subsidiary ‘A’ rated by SP&P, a commitment to long-term bondholder and counterparty security, and the philosophy of maintaining a rating close to “AA” through a highly rated insurance company such as AIG while pursuing an ‘A’ rated business strategy. The SPE owned credit-default swaps that could rise or fall based on the fortunes of a list of residential mortgage-backed securities based on subprime loans.

The Abacus 2007-AC1 was not the first synthetic CDO deal promoted by Goldman Sachs. It was preceded by one called the Hudson Mezzanine; a two billion dollars deal. At this point, it is easier to look at a synthetic CDO as an insurance policy that enables a bank to bet that people would or would not pay back their mortgages. If the mortgages are paid as scheduled, the policy holder will continue to make a steady payment of relatively small amounts. But if the mortgage fails like in the case of a market collapse, the policy holder would receive a huge reward from the insurance. As such, when Goldman Sachs bought mortgages and created mortgage backed securities, it did two deals at the same time. In the first deal, it offered the MBS investment to customers who believed the mortgages would pay off and it collected a fee from them. In the second deal involving the Hudson Mezzanine, it used its own money to bet against the same MBS it created and sold to investors, in anticipation of the housing bubble burst.

When traditional investment banking and trading occur in the same bank, the institution can use its money to bet

against its own clients, creating a conflict of interest. To prevent this from happening, the bank needs to proactively disclose this information to its customers. In the case of the Abacus 2007-AC1 synthetic CDO, Goldman Sachs marketed the deal without telling the investors that the securities they were buying were chosen in part by a client, hedge fund manager John Paulson, who believed that those securities would fail. When they failed, Paulson, made about one billion dollars according to Reuters.

5. Ethical Considerations of Synthetic CDOs in the Case of Goldman Sachs

Ethics is the discipline that analyzes moral standards of individuals, organizations, and society as a whole (Hollowell, Clarkson, Miller, and Cross, 2011; Velasquez, 2012). It is the study of what can be seen as right or wrong behavior, and it focuses on the application of what constitutes moral standards and behaviors in daily societal life. At a business level, ethics investigate three different types of issues: systemic, corporate, and individual. There are many ethical theories that explain activities in the business environment and help drive good moral behavior, while ensuring the accomplishment of the business' end goal of making a sustainable profit. An understanding of ethics at a business level is necessary to define business viability, employee well-being, and customer welfare.

5.1 Ethical Dimension

Ethics deal with rights and wrongs; it goes beyond the legal part of the decision and considers its morality (Hollowell et al., 2011). Goldman Sachs' actions did not go against any existing law, but implemented the provisions of the new law that repealed the Glass-Steagal Act of 1933, allowing the company to do commercial banking and investments at the same time. Only, it is morally wrong for a firm to package and sell mortgages to investors, collect fees on the front end for packaging these mortgages, then betting that these mortgages will fail on the other end.

Once this practice was uncovered, the Securities and Exchange Commission filed a civil suit on April 16, 2010 against Goldman Sachs, accusing the company of securities fraud on the premise that the company created and sold mortgage investments secretly designed to fail (U.S. Securities and Exchange Commission, 2010). As a result, Goldman Sachs agreed to pay \$550 million to settle the charges of misleading investors with its synthetic CDO, a subprime mortgage product. This was the largest penalty ever paid by a banking institution at that point, confirming that the company's acts were ethically concerning. In what follows, these acts will be analyzed using various theoretical perspectives.

5.2 Systemic, Corporate, and Individual Ethical Issues

Business ethics investigates three types of ethical issues: systemic, corporate, and individual. According to Velasquez (2012), systemic issues are questions pertaining to political, economic, social, technical, and legal institutions, including other organizations with which firms operate. As illustrated by Shaw (1988), systemic issues are of the same magnitude as unemployment, inflation, pollution, or the national debt. They raise questions regarding the morality of laws, regulations, structures, and social practices. Systemic issues can arise when new laws are created, when existing laws are modified, or when organizations make decisions that have consequences and repercussions on other organizations.

Corporate ethical issues are questions specific to an organization regarding the morality of its policies, structure, activities, and practices. The objective of businesses being to make a profit, firms can easily corrupt normal practices at a core level in their quest for profit, raising a corporate ethical issue (Moore, 2005). Individual ethical issues are mainly behavioral and decisional questions about a specific individual or group of individuals in an organization (Maxwell-Smith, White, & Loyd, 2020; Velasquez, 2012). These include questions on decisions to conduct business in one way or another. These questions look at the morality of the decision and actions taken, as well as the character of the individuals making the decision.

From 2004 to 2008, Goldman Sachs issued 25 Abacus deals worth a total value of almost \$11 billion (Faber, 2010; The New York Times, 2010). This new synthetic CDO product offered by Goldman Sachs uncovered a systemic issue. Indeed, this product capitalized on a new law known as the Gramm-Leach-Bliley Act of 1999. It demonstrated the limitations of the law and raised questions regarding the morality of that law. As such, a solution needed to be found at a higher level, that of the government.

At a corporate level, the synthetic CDO exposed the morality of the company's leadership that was focused around making the most profit possible and not taking care of the customers. As such, the morality of the company's policies, activities and practices is questioned with the introduction of a product sold to customers in anticipation of their failure. These issues can be better analyzed using the lens of different ethical theories.

5.3 Kohlberg's Theory of Moral Reasoning

Managers often deal with moral and ethical issues in their daily work. They use a set of moral reasoning and principles to resolve these issues (Weber, 1991). Hence, understanding the decision-making process in the presence of ethical or moral dilemmas is of great importance.

After more than 20 years of research in an effort to understand the phases of moral development and the types of moral reasoning created from childhood to adulthood, the psychologist Lawrence Kohlberg identified six levels of moral development (Velasquez, 2012; Weber, 1991; Kohlberg and Hersh, 1977). Kohlberg (1977) hypothesized that individuals follow six sequential phases in their moral development and grouped these phases into three levels of two states each (Forte, 2004; Kohlberg and Hersh, 1977; Velasquez, 2012).

The first level of moral development known as the preconventional level is when a child applies the labels right, wrong, good, and bad, to things that result in pleasant or painful outcomes, punishment, or reward. The two states at this level are punishment and obedience orientation for the first stage and the instrumental and relative orientation for the second stage.

At the second or conventional level, the young adolescent understands moral rights and wrongs in terms of familial, group, societal, or national norms. This level contains the third and fourth stages of Kohlberg's moral development phases. The third stage is the interpersonal concordance, when the adolescent focuses on how others think about him or her. The fourth stage is the law and order orientation, when rights and wrongs are based on loyalty to society and to the nation.

The third and final level of Kohlberg's theory of moral reasoning is known as the postconventional, principled, or autonomous level. It occurs when a person starts looking at rights and wrongs from an objective standpoint, taking various interests into consideration. This level contains the fifth and sixth stages of development. The fifth stage or social contract orientation occurs when a person believes in the relativity of moral values and norms. The sixth stage is the universal moral principles orientation that occurs when a person sees rights and wrongs in terms of moral principles dealing with human rights, justice, and social welfare among others. Kohlberg's (1977) theory of moral development has been extended by various psychologists and researchers. For example, arguing that the theory failed to identify women's development, Carol Gilligan extended it to the moral development of women (Baugher and Weisbord, 2009; Velasquez, 2012).

From the standpoint of Kohlberg's theory of moral development, Goldman Sachs' leadership acted at the first or preconventional level when a person applies the labels right, wrong, good, or bad to things that result in pleasant or painful outcomes. In this case, because it acted within the boundary of existing laws (Faber, 2010; Beattie, 2010), Goldman Sachs believed the label applied should be "right." In addition, because it was making more profits, it would also apply the label "good" to its activities.

Looking at the second level of Kohlberg's moral development known as the conventional level, the company failed to understand moral rights and wrongs in terms of societal or national norms. Blinded by the need to maximize its profits, the company saw the limits of the Gramm-Leach-Bliley Act and capitalized on it after contributing in its lobbying. Without achieving the requirements of the Kohlberg's conventional level of development, the company could not look at its acts in terms of rights and wrongs from an objective standpoint.

Even though some researchers argue that Kohlberg's stages of moral development are sequential and one has to gradually go from the first stage to the sixth (Mulligan, 1986; Shaw, 1988; Kohlberg and Hersh, 1977), the case of Goldman Sachs proves otherwise. Indeed, knowing that a company is a legal structure with the same type of rights as an individual citizen, it is understandable that Kohlberg's stages of moral development should be applicable to companies. As such, the case of Goldman Sachs and the synthetic CDO demonstrates that companies can go in either direction in Kohlberg's stages of moral development when new laws are signed or when a new management team is appointed.

5.4 A Kantian Perspective

Kant distinguishes the duties of virtue from the duties of justice, the prior being categorized in ethics and the latter in rights. In demonstrating that there are rights and duties inherent to every human being, Immanuel Kant (1724-1804) based his theory on moral principles also called categorical imperative on the belief that everyone is considered free and equal to everyone else (Tan, 1997; Velasquez, 2012). As such, Kant formulated two versions of his categorical imperative.

Kant's first categorical imperative suggests that one should not do onto others what he or she does not want to see become a universal law, one which everyone can implement in similar situations. As such, this categorical imperative requires two criteria in order to determine rights from wrongs: universalizability and reversibility.

Universalizability suggests that the decision can be repeated by everyone in the same situation. Reversibility suggests that the decision should be the same if roles were reversed and the person considering making the decision was now subject to the decision. Kant's first categorical imperative is similar to the golden rule which states, as explained by Velasquez (2012), "do unto others as you would have them do unto you" (Matthew 7:12; Luke 6:31).

The second formulation of the categorical imperative suggests that an action is morally right if two conditions are met. First, the person performing the act or making the decision should not treat others as means to advance his or her agenda. Second, the people subject to the decision or act should freely consent to be treated as such, and the decision needs to contribute to their ability to pursue what they chose (Velasquez, 2012). This formulation of the categorical imperative implies that people should not be used as tools, nor manipulated, or deceived. As Duran and McNutt (2010) explain, Kant believed that it is not the outcome that made an action morally worth, but the motive behind the action, thus the formulation of the categorical imperative.

From a Kantian point of view, the categorical imperative requires everyone to be treated as a free person and as an equal to everyone else. Looking at the principles of universalizability and reversibility of the first formulation of Kant's categorical imperative, the question to the leadership of Goldman Sachs is that of knowing if they would like others to sell them such product if they were on the other side of the negotiations. This question can be answered with the information on hand because the company bet against the deals sold, meaning that the leadership of the company would not like someone to sell them such products. Yet, the company continued selling the product to its customers, defeating the principle of reversibility.

Looking at the situation from the second formulation of Kant's categorical imperative, the company should not treat its clients as means, but always also as ends. Knowing that Goldman Sachs packaged the synthetic CDO and sold it to customers then bet against them indicates that the company was mainly using its customers as means for making more money. In addition, the product did not contribute to the customers' ability to pursue what they had freely and rationally chosen to pursue, because it was designed to fail and provide money to Goldman Sachs both when the product was sold and when it failed. Based on Kant's categorical imperative, the actions of Goldman Sachs were not morally right, and this was confirmed in the lawsuit that followed.

5.5 A Utilitarian Perspective

Utilitarianism according to Renouard (2011) is a philosophical line of thought that seeks to maximize the utility or benefit of the highest number of people. As a consequentialist perspective, it mainly looks at the outcome regardless of the intentions. Utilitarianism evaluates actions and policies based on the benefits and costs or harm to everyone in a society (Velasquez, 2012). According to utilitarian principles, in any situation, the morally right thing to do is the one that will produce the greatest utility to everyone affected. Utility is seen here as the balance of benefits compared to costs. Cost in this case refers to anything that is negative, like dissatisfaction, unhappiness, sickness, pain, or even death. Utilitarian theorists believe in doing what is best not for one person, but for all of society.

One of the advantages of utilitarianism is its explanatory power for moral acts. Indeed, utilitarianism has been successful in explaining why some actions like lying or infidelity are morally wrong, while others such as truth or fidelity are morally right. For example, infidelity is wrong because when there is infidelity, there is lack of trust. As such, people do not cooperate, and welfare declines. Fidelity on the other hand strengthens relationships and creates a good environment that increases productivity.

Utilitarian views have also been helpful in economics. Their contribution encompasses topics such as supply and demand curves, price equilibrium in perfectly competitive markets, utility maximization with Pareto optimality, cost-benefits analysis, and even efficiency which consists of "operating in the manner that produces the most from a given amount of resources, or that produces the desired output with the lowest resource input" (Velasquez, 2012, p. 83).

On a different note, utilitarianism faces many critics. Mariotti (2004) explains that utilitarianism cares about the production of the greatest amount of utility and considers irrelevant the proper distribution of the sum of utilities. This could be a source for potential ethical issues. Other problems regarding the utilitarian approach deal with the measurement of total utility. In other words, what is the value given to instrumental goods considered valuable because they lead to other good things? The same question can be asked of intrinsic goods such as life, health, or happiness. To these questions, utilitarians answer that intrinsic goods like life have priority over instrumental goods such as money or food (Velasquez, 2012).

Looking at the case studied here, it is difficult to present the benefits of the synthetic CDO to society from the

utilitarian standpoint. Indeed, this is a one way product created and designed to primarily serve the purpose of Goldman Sachs and its partners. As such, some customers might have made profits, but the majority lost most of their wealth. Overall, the risk of the product to society outweighs its benefits. This was indeed confirmed by the effects of the product on the housing bubble as explained by Byun (2010), Holt (2009), and Parkes (2011). Hence, the commercialization of the synthetic CDO was not morally right as supported by the utilitarian principle which suggests that the morally right thing to do in any situation is the one that will produce the greatest utility to everyone affected.

5.6 Friedman's Shareholder Theory and Corporate Social Responsibility (CSR)

Corporate social responsibility refers to a firm's responsibilities to society (Appiah, J. K., 2019; Saha, 2019; Velasquez, 2012). The definition of these responsibilities is still unclear to some, but researchers have successfully adopted different viewpoints that help understand the concept in today's environment. The first viewpoint is that of Milton Friedman (1927-1987) with his shareholders theory and the second is a less extremist view, that of the stakeholder theory.

Milton Friedman argues that corporate executives work for the owners of the company who are all shareholders. As such, executives have the obligation to run the company as the shareholders desire, which is to make the most profit possible while staying within the boundaries of law and ethics. Friedman's only view of corporate responsibility as expressed by Krishnan (2011), Mulligan (1986), and Shaw (1988), is that of making as much profit as possible in order to maximize the shareholder's return. This is confirmed by Velasquez (2012) who explains that Friedman's shareholder view of corporate social responsibility suggest that a company executive has no right to increase employees' salaries or give money for social causes, unless doing so will increase the company's profits, hence the shareholders' return. For instance, if giving money for social causes can reduce corporate taxes and increase profits, the managers have the obligation to proceed with this act of social responsibility. Friedman argued that exercising social responsibility actions that do not increase shareholders' return is unfair and constitutes taxation without representation (Mulligan, 1986). Many critics have discussed and refuted Friedman's views. Some object to the claim that company executives are employees of the shareholders, asserting that the executives are employed by a legal structure, the company of which the shareholders own part of the profits and losses.

Friedman's shareholder theory explains and supports what happened in the case of Goldman Sachs and the synthetic CDO. This product helped the company maximize its profits, thus the shareholders' return. In addition, it did so without breaking any law, making it morally acceptable. Only, looking deeply into Friedman's shareholder theory, the act also needs to be ethical. At this point, it will be difficult to consider the act as ethical or not, when looking at the theory for guidance. This brings up another question regarding the shareholder theory: is it ethical to always want something back in return of every act posed? In other words, is there anything good that does not serve self-interest? The action of Goldman Sachs can be explained as morally correct based on Friedman's shareholder theory. In the process of doing so, it uncovered the underlying issue of explaining the position of selflessness within this theory. In addition, based on the fact that society recognized Goldman Sachs' acts as unethical, how can this be classified as moral using the shareholder theory? Some critics of the shareholder theory simply present a different view of corporate social responsibility, one that looks at the stakeholders.

5.7 The Stakeholder Theory

Two pioneers of the stakeholder theory, Edward Freeman and David Reed define a stakeholder as any individual or group that can influence or be influenced by the achievement of a company's goals (Velasquez, 2012). A stakeholder has a stake in a company's activity and this stake can be harmful, beneficial, or influential to either party. For example, a company such as Goldman Sachs impacts its customers' lives with its products, its employees with their wages, the communities in which it makes business with its buildings and social programs, stockholders with the dividends, and the local and federal governments with the taxes it pays. Goldman Sachs also impacts its suppliers by purchasing equipment and services from them, leasing space, or sub-contracting work with them. As a result, these customers, employees, communities, stockholders, governments, and suppliers all have a stake in Goldman Sachs' operations and are thus stakeholders of the company. What about interest groups, activist organizations, or even the media? They can all become stakeholders if part of their activities is related to the operations of the company.

According to the stakeholder theory, a firm needs to be managed in a way that is profitable to all its stakeholders, not just to its shareholders (Krishnan, 2011; Savage, et al., 2010; Stieb, 2009; Velasquez, 2012). Profits can come in various forms such as higher dividends for the stockholders, higher bonuses for the employees, or more taxes

paid to the government. As such, managers should run the company with all stakeholders in mind. In return, these stakeholders will do their best to support the company's activities, resulting in a possible increase in benefits for everyone.

From a stakeholder's perspective, it can be argued that Goldman Sachs had only one interest in mind, that of Goldman Sachs and its shareholders. According to the stakeholder theory, the company should be run in a way that serves not just its shareholders, but also customers, employees, communities, governments, and suppliers among others. The presentation of the Abacus 2007-AC1 confirms that Goldman Sachs did not have the interest of its customers in mind, mainly because it bet against what it was selling and failed to provide customers with the necessary information to make a proper choice and decision. In addition, it can be argued that the company did not have the interest of the government and society because its actions show that it was getting ready for something bad like a housing market collapse that would affect the society in which it was doing business. Overall, Goldman Sachs' offer of the synthetic CDO was not morally right based on the stakeholder theory, but it can still be analyzed from other perspectives such as the market approach to consumer protection and the contract view.

5.8 Consumer Protection: Market Approach, Contract View, and Synthetic CDO

5.8.1 The Market Approach to Consumer Protection

As explained by Velasquez (2012), the market approach to consumer protection suggests that the free market mechanism will protect consumers from harm and injury. As such, it prohibits any government intervention that is believed to create inefficiencies and unfairness. This is a short-sighted view of reality because not all consumers are rational utility maximizers and most will select a product mainly due to necessity and associated costs. Other challenges arise with information and communication technologies as explained by Winn and Jondet (2008), where consumers become producers with the rise of social networks. There have been other approaches to address ethics and marketing problems.

Advertisement has for a long time been seen as a source of information for new and existing products. Unfortunately, recent events have uncovered deceptive practices from companies that took advantage of customers. An example of such abuse as presented by Velasquez (2012) was perpetuated in California in 2003 by AT&T, then Pacific Bell. The company renamed an expensive package and called it "The Basic." As such, customers looking for the basic package were duped into buying the expensive renamed one. Another deception from AT&T occurred in 2010 when the company overbilled customers for excess data usage when the customers had in fact not used any data over their limits (Velasquez, 2012). In both cases, the company was fined \$15 million and \$17 million respectively for deceptive marketing and deceptive consumer practices. This is an example among many that demonstrate the need for consumer protection.

5.8.2 The Contract View of the Firm's Duties to Consumers

The contract view of the firm's duties to its customers suggests that the relation between a company and its customers is a contractual relation and the company has a moral duty to the customers based on this implied contract. This moral duty is composed of the duty to comply and the duty of disclose.

The duty to comply is a fundamental moral duty any business has toward its consumers. The firm needs to provide the products promised along with the characteristics and features advertised to its consumers. Hence, any claim made by the firm is a contract presented to potential parties and a consumer purchasing the advertised product expects to see the contract fulfilled. The contract view also suggests that two parties in an agreement need to know what they are agreeing to and need to freely make their choices (Velasquez, 2012); this is the duty of disclose.

There are other moral duties to consumers under the contractual theory such as the duty not to represent and the duty not to forcefully persuade or coerce. However, the duty to comply and the one of disclose are essential in addressing problems in ethics and marketing.

In addition to the contractual theory, firms should understand and agree with the due care theory. This theory suggests that sellers or manufacturers understand the product sold better than consumers and are thus in a vantage position. For this reason, consumers rely on sellers who have the duty of taking better care of the consumers. In addition, by proactively taking good care of consumers, vendors will acquire and develop moral virtues as explained by Argandoña (2011), because they will strive to achieve what is good for others.

5.8.3 The Synthetic CDO: Market Approach to Consumer Protection and Contract View

As previously explained, the duty to comply is the most basic moral duty a firm has toward its consumers. For

that reason, Goldman Sachs needed to provide the products promised to its customers along with the characteristics and features advertised. Only, the company failed to communicate all the characteristics of the products, keeping secret the ones that could dissuade the customers. Indeed, this fact was acknowledged during the investigations of the Permanent Subcommittee on Investigations (U.S. Securities and Exchange Commission, 2010). As such, the company's acts defeated the duty to disclose that suggests that two parties in an agreement need to know what they are agreeing to and freely make their choices. Hence, Goldman Sachs was in a more advantageous position while selling its products to investors and exerted that vantage position by betting that the product sold to the customers would fail.

6. Guidelines and Public Policies for Dealing with Similar Situations in Future

6.1 Lawful Recognition of the Product and Requirement to Be of the Utmost Good Faith

Synthetic CDOs constitute one of the financial innovations that outpaced the creation of legal principles to control fraud and abuse. As shown in what precedes, this type of product can easily create a conflict of interest between a firm and its customers. Indeed, a firm can market products knowing that they will fail and at the same time protect itself against product failures through the implementation of a mechanism similar to that of the synthetic CDO, a type of insurance policy. What could Goldman Sachs have done to stay within a good ethical boundary?

To make a product like the synthetic CDO ethical, the product first needs to be recognized by law as an insuring mechanism and be required to be *uberrimae fidei* (of the utmost good faith), providing the highest standard of honesty and proactive disclosure of facts. In the SEC case against Goldman Sachs, one of the reasons that prompted such a high penalty was the company's omission to inform its customers about the role played by another client. Indeed, in the selection of the mortgages constituting the synthetic CDO Abacus 2007-AC1, Goldman Sachs partnered with the hedge-fund manager John Paulson, but failed to reveal this detail to other customers. Hence, full and proactive disclosure is required for such products to have some ethical characteristics.

6.2 Prohibition of Complex Products

Another solution for the company to stay ethical as it has always been would consist of not providing such complex and sophisticated products because of the confusion they have created and can still create not only to the customer, but also to the company's employees who have difficulties understanding it. This seems to be the solution chosen by Goldman Sachs and the company explained that it was putting an end to this product as a result of losses incurred by many investors and the financial market. In other words, the company does not provide synthetic collateralized debt obligations anymore.

6.3 Public Policy Modification: The Dodd-Frank Act

The synthetic CDO and other mortgage backed securities are non-uniform securitizations with a global impact (Bernard, Semmler, and Schron, 2011). Originated in the 1990s, these securities grew with the mortgage boom and became famous after the repeal of the Banking Act of 1933 by the Financial Services Modernization Act of 1999. Being a systemic issue, a solution needed to be found at the governmental level to prevent this issue from happening again.

To this end, a law was needed to regulate the financial system once more and protect consumers. Two congressmen, Representative Barney Frank and Senator Chris Dodd introduced a bill called The Wall Street Reform and Consumer Protection Act of 2009. On July 21, 2010, President Barack Obama signed this bill into law under the appellation Dodd-Frank Act (The White House, 2011).

The goal of the Dodd-Frank Wall Street Reform and Consumer Protection Act is to prevent another crisis by regulating the financial markets. As such, it seeks to protect investors and consumers from lending institutions and practices (Federal Reserve Consumer Help, 2013). The act contains reforms in many different areas such as consumer protection, financial system oversight, bank gambling prevention, credit rating agencies regulation, and much more (Anenberg, et al., 2010; Hutington, 2010; Koba, 2012; Morisson and Foerster, 2010).

As an example of solution for consumers' protection, the act created an independent agency called the Consumer Financial Protection Bureau (CFPB). The goal of this agency is to protect consumers from deceptive practices like hidden fees and to make sure mortgages and credit card information among other financial services are available (U.S. Senate Committee on Banking, Housing, and Urban Affairs, 2010).

Regarding the oversight of the financial system, the act created a new structure, the Financial Stability Oversight Council (FSOC). The role of this council is to identify potential risks in the financial industry and to oversee non-banking financial establishments such as hedge funds (U.S. Securities and Exchange Commission, 2013). In

this regard, this structure can recommend the dismantling of complex or large companies or recommend the increase of reserves in order to avoid another situation as that of AIG.

To prevent banks from betting with customers' deposits, the Dodd-Frank Act enacts the Volcker rule. This rule prevents banks from investing in hedge or equity funds with the goal of making a profit. It also creates a program encouraging whistleblowing with a reward of up to 30 percent of the funds recovered.

6.4 Social and Political Context

Kraft and Furlong (2013) explained that policies are affected by the political, economic, and social conditions. In the case of the new law, all three conditions were in alignment with the type of decisions taken. The effects of the 2008 crisis were still being felt all over in the country and experts agreed that one of the causes of this condition was the repeal of the Glass-Steagall Act of 1933 and the housing bubble that followed (Crawford, 2011; Holt, 2009; Rahman, 2012). In that case, any law that would set the records straight again and suggest means to prevent such things from happening would be accepted by the public opinion and by means of representation, the respective representatives.

From a political perspective, the act was introduced during a reelection period and few elected officials seeking reelection would oppose a law aimed at preventing another financial crisis. As such, just like the social climate, the political climate was also propitious to the acceptance of the act. Presented as a contributor to a possible economic rebound due to market oversight, the economic climate was in alignment with the social and political climates for the passing of the law.

7. Discussion and Conclusion

Very often, due to their cultural beliefs or the lack of adequate knowledge, people see events occur in the world and fail to identify possible impacts to their professional environment and to their lives until it is too late. The housing bubble burst is one of such events. The American population and the world watched this unfortunate event unfold in front of them, thinking it would stop, it could not happen, or it would have no immediate impact on their professional activities or their personal wealth. When reality finally struck, companies such as Lehman Brothers and Countrywide Financial either declared bankruptcy or were acquired by other companies (Holt, 2009). Individual investors lost their wealth as stock markets plummeted and those who did not see themselves as investors were hit with reality when they saw the value of their 401(k) drop among other things. Furthermore, the crisis created an unprecedented loss of jobs in every industry, starting with home construction (Byun, 2010).

One of the companies pointed out for their participation in the house bubble and the burst was Goldman Sachs, and this study presented the extent of its involvement. With its synthetic CDO product named Abacus 2007-AC1, Goldman Sachs deviated from its ethical culture. Analyzing the offering of this product from various ethical theories, this study uncovered information that can be considered contribution to knowledge.

The first contribution to knowledge came from the analysis of Goldman Sachs and its Abacus product from the perspective of Kohlberg's theory of moral reasoning. In their study, Kohlberg and Hersh (1977) explain that the moral transformation of a person follows a forward movement and never goes backward, except in case of severe trauma. Because a company is a legal entity with rights and responsibilities like an individual, the application of Kohlberg's theory to firms makes sense as demonstrated in this study. Only, the study found that in the case of organizations, the movement of the organization through Kohlberg's stages of moral development could go forward as well as backward. Situations in which it could go backward occur when company executives are replaced and new executives bring new orientations, or when there is a significant change in the business environment. Such change could be due to competition, new laws, or other economic or technological challenges. This idea could not be found in the literature and constitutes a possible contribution to knowledge.

Another contribution to knowledge is related to Friedman's shareholder theory. Of all theories applied in this study, everyone resulted in the classification of Goldman Sachs' acts as not being morally correct, except Friedman's shareholder theory. This brings up a lingering question: if society recognized Goldman Sachs' acts as unethical and fined them with the highest penalty a financial firm had ever had to pay, how can this same act be classified as moral using the shareholder theory? Is this a limitation of the theory or was something missed along the way? Further research will be required to answer this question appropriately. The case analyzed in this study shows the importance of ethical behavior in companies. Even though the goal of every firm is to make a sustainable profit, that goal should not be followed without guidelines, rules, and values that take into account the moral and ethical dimension of conducting business.

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