Salomon Brothers: "Apologies are Bullshit"

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1. The Mozer Crisis

Paul Mozer, Managing Director of Salomon Inc.'s government securities trading desk, submitted three separate bids for the U.S. Treasury's $9 billion 5-year treasury note auction on Feb. 21, 1991.

Each of the bids was for $3.15 billion, or 35% of the total bond offering, the maximum bid the Treasury would recognize from any individual buyer. Since two of the bids were submitted under the names of outside firms who were Salomon customers, Warburg and Quantum, everything appeared legitimate, and the Treasury accepted all three bids.

The Treasury was unaware that only Mozer's bid in Salomon's name was legal. The other two were unauthorized customer bids placed by Mozer in an attempt to garner for Salomon a larger portion of the auction than allowed by Treasury rules.

Mozer's combined bids for 105% of the auction offering amount were awarded at a 54% proration, for a total of 57% of the issue, or $5.1 billion.

Mozer believed his plan had succeeded. Playing by the rules would have garnered Salomon only $1.7 billion of the $9 billion in notes offered, or 19% (54% of 35%). Mozer arranged for the customer confirmations of the unauthorized bids to be suppressed, and purchased the notes for Salomon through S.G. Warburg's and Quantum's accounts without their knowledge. By falsifying two customers' bids, Mozer had tripled Salomon's play and payoff.

Salomon, Inc., Wall Street's heaviest hitter in large volume securities and bond trades, had landed a huge score. Mozer and his group of treasury traders at Salomon would reap the benefits, in terms of profits and prestige.

What Mozer didn't know was that S.G. Warburg had also participated in the Feb. 21 treasury auction: submitting a bid in its own name for $100 million, barely over 1% of the $9 billion offering. To the U.S. Treasury, it looked like two bids from one buyer for 36% of the value of the notes offered, a violation of its bidding rules.

This small crack in Mozer's scheme eventually turned into a disastrous chasm. The full extent of Mozer's fraudulent trading behavior was soon uncovered, and within a year Mozer had been fired, and his superiors at Salomon, all the way up the chain to CEO and Chairman John Gutfreund, were forced to resign in disgrace. Salomon's reputation never recovered.

How did the top U.S. underwriter of securities reach this sorry state of affairs? A wide variety of explanations have been offered: deficiencies in the ethics of the individuals involved, the absence of managerial controls, or that Salomon's fate was simply a product of the times.

2. The Beginning

Salomon Brothers was founded in 1910 by three brothers--Arthur, Herbert and Percy--along with a clerk named Ben Levy. The company was primarily a bond trading firm, which made money by being on the winning side of its trades. In order to survive in what was then a marginal segment of the industry, Salomon had to provide rapid and superior service and to maintain a reputation for honesty and integrity. Additionally, the firm risked its own capital to make money because it did not have fee-paying clients. The private company entered equities in the mid-1960s and investment banking in the early 1970s.

Until 1981, Salomon operated under a partnership structure, which engendered a tightly knit culture and reinforced cohesiveness among its employees. The firm earned much of its money by investing in the market. To do this, it required that partners keep a substantial portion of their wealth in the firm. If a partner left the firm, he forfeited a portion of his investment. Thus, partners were highly motivated to put the firm's health before their own activities.[1]

Battles over credit for deals and trades were minimal because compensation among partners was essentially equal. In addition, owning the firm motivated the partners to keep a close eye on expenses. As Salomon partner Abraham Eller once explained, ". . . what helped make Salomon Brothers was not only the partners, but that the men they hired were hungry.… We weren't the sons of rich men."[2]

Bond Traders and Salesmen

More than any other concern on Wall Street, Salomon was run by its traders -- the people closest to the money. The traders spent their time trying to extract information about likely price movements of securities from the price movements of related instruments. In trying to gauge market sentiment, they worked closely with the salespeople who sold to their institutional customers, such as pension funds and insurance companies. The salespeople, in turn, provided information to the traders about the sentiment within the investment community as well as creating an outlet for the securities that the traders had acquired. The basic skills required for the two jobs were quite different. Traders required market savvy. Salespeople required interpersonal skills.

3. Forces of Change: External influences on Salomon's business

The 1970s and 1980s were challenging decades for Wall Street firms. The world was changing rapidly, and the top firms found they needed new skills to stay on top.

Emerging from the turbulent 60s, the U.S. government was running chronic deficits, bearing the legacy of LBJ's Great Society domestic programs and the continuing costs of the war in Vietnam

in a recessionary, risk-averse environment. Faced with a weakening dollar and stagflation—inflation in a stagnant economy—President Richard Nixon in 1971 imposed an array of restrictions on imports, instituted wage and price controls, and slashed the budget.[3] Those measures were largely ineffectual, and matters were further exacerbated when the Organization of Petroleum Exporting Countries (OPEC) boosted the price of oil in 1973, launching the energy crisis that reverbrated throughout the economy. The effects were most heavily felt in the auto industry and other heavy industry sectors. The steel belt started its decline to become the rust belt, and interest rates grew to double-digits.

In the capital markets, expansion-minded corporate managers found buying out the depressed stocks of beleaguered companies more attractive than investing in new facilities.[4] As manufacturing firms' stock prices dropped sharply, the true value of underlying assets exceeded their stock value, and these companies became cash acquisition targets. The cheap dollar and devalued share prices fueled the creation of a new merger and acquisition movement.[5]

Trading equities had once been Wall Street's greatest source of revenues. However, when fixed stock brokerage commissions ended in 1975, commission income collapsed as investors were able to shop for brokers competitively. Revenues across Wall Street fell by approximately $600 million in 1976.

The "rules" by which economists had lived for generations seemed to have been broken. Inflation was roaring in a sluggish economy.[6] Many firms on Wall Street suffered losses struggling with the changed economic landscape. Salomon Brothers, on the other hand, remained profitable through the seventies. Always regarded as a brash specialist in bond trading, Salomon Brothers spent much of the seventies aggressively expanding and innovating its underwriting business. Its key strengths were a large capital base, a broadly based and efficient distribution network, and entrenched franchises in specialized areas.

Deregulation

Fortunately for Wall Street, the golden age of the bond man arrived in late 1979 when the Federal Reserve announced that the money supply would cease to fluctuate with the business cycle.[7] Interest rates, and bond prices, would now swing widely, with bond prices moving inversely to interest rates. Bonds were no longer the conservative choice for investors who didn't want to chance the equities market; they became a means of "creating wealth rather than merely storing it."[8]

As bond volatility increased, so did volume. Consumers, governments and corporations borrowed money at a faster rate than ever before. Salomon was booking more and more bond trades: some salesmen went from moving $5 million a week to $300 million in merchandise a day.[9] The industry's revenues rose from $16 billion in 1980 to $51.8 billion in 1988.[10]

In 1981, Congress passed a tax break which allowed thrifts (i.e., savings banks, savings and loan associations, and credit unions) to sell all their mortgage loans in order to put their money to work for higher returns. Subsequently, the volume of outstanding mortgage loans increased from

$700 billion in 1976 to $1.2 trillion in 1981, and the mortgage market surpassed the combined U.S. stock markets as the largest capital market in the world.

The SEC's Rule 415, enacted in 1982, was designed to speed the flow of securities from issuers to investors. Corporations were allowed to register in advance all the securities they intended to issue over the next two-year span ("shelf registrations"),[11] and offer any of them at any time. A company could bring debentures, for example, to market whenever rates and acceptance seemed best,[12] selecting an underwriter and giving notice at the last minute. This intensified competition.[13] One insider said, "We're moving from the traditional concept of marriage to one-night stands."[14] Underwriters had to "hone their sensitivity to the market,"[15] and be prepared to commit large sums of money on very short notice. Under the new system's first full year of operation, shelf registrations accounted for 38% of all underwriting volume, and Salomon Brothers was the industry's leader.[16]

The protection of the Glass-Steagall Act, which had forbidden commercial banks to underwrite and distribute most securities, all but disappeared. Giant financial houses emerged, offering across-the-board financial services. Investment firms found themselves free to invent and price new products in "a perpetual storm of invention."[17] To take advantage of rapidly emerging opportunities, products were more innovative and complex, while their life cycles decreased (often to a few days).

Many of the exclusive relationships that had been common in earlier periods were breaking down. In the past, most companies had ongoing relationships with investment bankers, which were handed down from one generation of the company to another.

Relationship banking was giving way to transactional banking: traditions mattered less, and price was the driver, one deal at a time. As constant competition shrank margins on traditional products, investment houses had to either increase volume or diversify into higher margin products.[18]

4. Gutfreund's leadership

In 1978, Billy Solomon, the son of one the founding Solomon partner's, announced that John Gutfreund would be the new Managing Partner. Gutfreund had grown up in the suburbs of New York, the son of a trucking company owner and a family friend of Billy's since childhood. Gutfreund had joined the firm in 1953 after graduating from Oberlin College with a degree in English and serving two years in the Army. While he started in the statistical department, once there, he advanced quickly into trading municipal securities. He became a partner in 1963 and joined the Executive Committee three years later.

When Gutfreund took over the firm, there were 28 partners -- 13 "had not been to college, and one hadn't graduated from the eighth grade." With an English degree from Oberlin College, "John Gutfreund was, in this crowd, an intellectual."[19] He was also noted as being the most conservative member in the firm. Later, observers would describe Gutfreund as a "supremely self-confident, intellectual, ferociously competitive individual who was a throwback to the days

on Wall Street when partnerships reigned and the personality of one man could dominate a firm."[20]

In the 1970's, John Gutfreund and his colleagues were among the earliest to capitalize on the changes in investment banking. The role and status of bankers charged with raising funds and providing advice and liquidity to clients was evolving rapidly. Gutfreund's syndicate department (the group that organized underwritings) became efficient at undercutting Wall Street rivals, and became the most powerful entity within the firm.[21]

Gutfreund also saw the key role of innovation and supported pioneering efforts in various fields. With Gutfreund at the helm, Salomon would thrive by its ability to be in the right place at the right time, with the willingness to move quickly. When mortgage markets took off after 1981's tax breaks to thrifts, Salomon Brothers had the only fully staffed mortgage department on Wall Street. As a result, Salomon pioneered and dominated the multibillion dollar mortgage-backed securities market. While competitors hesitated, Salomon made hundreds of millions of dollars in fixed income arbitrage.[22]

Gutfreund sought to take advantage of economic growth and pursued a strategy of aggressive expansion, both in the services the firm provided for its customers, and in the role of the company in the global marketplace.[23] Noting the trend toward a common capital market worldwide, he directed that offices be expanded and opened in London, Frankfurt, Tokyo, and Zurich. In addition, he broadened the firm's foreign currency exchange operations.

At the same time, Gutfreund realized that he needed additional capital resources to continue this path of expansion. As William Voute, a managing director at Salomon, later explained:

> We saw the size of the market expanding and the U.S. Treasury needs expanding. We had only in the neighborhood of $300 million in capital, and it was felt that this wasn't enough to bring us into the next century.[24]

Salomon Gets Bought Out

In 1981, Gutfreund arranged a buyout of Salomon Brothers by Philipp Brothers. Phibro, an international house with revenues of $23.6 billion, paid $554 million for Salomon. Phibro traded more than 160 commodities in 45 countries and was therefore one of the world's largest commodities traders at that time.[25] "It was a marriage of Salomon's ingenuity with Phibro's cash."[26] The sale abolished Salomon's partnership structure and made the firm a publicly traded institution.

The buyout negotiations were conducted in total secrecy and were only revealed to Salomon's partners when negotiations were completed. It was a move that shocked all of Wall Street because Gutfreund had always stated that he would never deviate from the partnership structure of the organization.[27]

Gutfreund became chairman of the Salomon Brothers subsidiary and co-chief executive (along with the Philipp Brothers chairman, David Tendler) of the newly formed holding company

Phibro-Salomon, Inc. As a result of the deal, Gutfreund received more than $30 million for his partnership shares.[28]

The access to Phibro’s enormous capital resources enabled Salomon to deal in larger volumes, take larger risks, and operate on lower profit margins. Gutfreund said “we’ve leapfrogged 20 years ahead. It explodes the size of our universe.”[29]

In 1983 the commodities markets experienced a downturn; the price of everything from gold to crude oil tumbled.[30] Phibro suffered: its traders earned only $307 million that year, while Salomon’s traders earned $463 million. Consequently, Salomon’s traders demanded control over the combined company. Gutfreund lobbied the board of the holding company to be named sole chief executive officer since the Salomon unit was producing most of the company’s profits. Tendler also appeared before the board in an attempt to be appointed sole chief executive. Gutfreund won. In 1984 he was named sole CEO and Tendler resigned. The name of the holding company was changed from Phibro-Salomon to Salomon, Inc.[31]

Gutfreund’s Stamp

Despite becoming Chairman and CEO, Gutfreund spent most of his time at a large desk overseeing one end of Salomon’s gymnasium-sized bond trading room. “I get great pleasure from being on the floor. Salomon is a trading house and I was a trader.[32] He was most at ease on the trading floor—the 41st floor, which was known as “Power Central”—exchanging expletives with the traders who worked for him. In fact, he was probably the most accessible chairman of any concern on Wall Street. “The nitty-gritty of deal-making, waging war with the weapons of quarters and eighths of a point were his joy.”[33] To the Wall Street competition, Gutfreund “was the Salomon culture incarnate”[34] with his instructions to trainees to come to work ready to “bite the ass off a bear.”[35]

At Salomon he fostered an environment where risk-taking and agility were rewarded—as long as you made money. The Salomon trading floor was unique. It had minimal supervision, minimal controls, and no position limits. That is, a trader could buy or sell as many bonds as he thought appropriate without asking. Very few other firms gave its traders such free reign to commit the assets of the firm. At Salomon, restraint came not from the top but from the relentless competitive pressures to turn profits and avoid losses.

Gutfreund’s success was to recognize and cultivate Salomon’s strengths in evaluating the value and risk of a wide range of securities. He had confidence in Salomon traders and was willing to back them up with his balance sheet.[36]

Michael Lewis, in his book *Liar’s Poker*, captured Gutfreund’s philosophy:

> When you won, people admired you, envied you, and feared you, and with reason: You controlled the loot. When you managed a firm, well, sure you received your quota of envy, fear, and admiration. But for all the wrong reasons. You did not make the money for Salomon. You did not take risk.[37]

5. New World Order

Through the early 1980s, Salomon was the undisputed leader in a number of low margin, high volume businesses, such as the underwriting of corporate bonds and trading in government securities and large blocks of stock.[38] In 1984, the firm was worldwide leader in underwriting securities, raising over $150 billion. Trading and sales reached $2.4 trillion, and total capital of the Salomon Brothers group was $1.7 billion at the end of the year.[39]

In 1985, the firm's peak year, Salomon brought in $760 million in pretax profits. In 1987, the company's capital reached $3.4 billion. Also, Salomon, which traditionally traded only a few products, was trading well over 100 products by 1987.[40] It was an era of seemingly uninhibited growth, fueled by bull runs in the stock and bond markets.

In order to accommodate this growth in businesses, Salomon opted to increase the size of its staff. The Salomon MBA training class of 1985 numbered 127 trainees--by far the largest class in Salomon's history. The 1986 class was twice as large.[41] The ratio of support staff to professional at this time was 5:1—500 additional support staff for every 100 new members. The firm, which had employed 2,000 people in 1982, tripled to 6,000 people by 1987.

As corporate growth increased, Salomon's traders, salespeople, and investment bankers focused on their own operations rather than the firm as a whole. As one insider put it, "competing fiefdoms replaced interconnected businesses."[42] Another former employee said, "Organizational structure at Salomon was something of a joke. In fact, organizational charts were not allowed--they were too disruptive. Making money was mostly what mattered."[43]

The different groups

Led by John Meriwether, **the "arb" group** was one of Salomon's great success stories of the late 1980s. Meriwether was one of the first to recognize that futures provided almost unlimited leverage for buying and selling securities by taking advantage of small differences in price.[44] It was also an easy way to sell securities that the firm did not own. Although other firms also recognized this potential, Salomon backed the strategy from the outset with very large bets.[45] As interest rates began fluctuating in the late 1970s and early 1980s, Meriwether's arb operation began earning enormous profits. In 1981, it made in excess of $100 million--one-third of Salomon's profits.[46] Senior management reacted by committing more of Salomon's capital to allow Meriwether to place bigger and bigger bets.

Since arbitrage was an unusual trading strategy, Meriwether did not recruit typical Wall Street employees; rather, he recruited his team from academia. His team was young, ranging in age from 25 to 32.[47] Most of them had Ph.D.s in math, economics, and physics. "Because their backgrounds and businesses differed from traditional traders, the 'arb' group took on an elite aura at Salomon."[48]

The **mortgage traders** at Salomon were also powerful during the 1980s. Formed in 1978, it was the most profitable area of the firm. Mortgage traders made $200 million in 1983 (40% of the firm's revenues), $175 million in 1984, and $275 million in 1985.[49] The group was led by Lewis

Ranieri, the Salomon legend who began in the mailroom, and worked his way onto the trading floor.[50] During the mid-1980s, the American mortgage market continued to grow faster than any other capital market in the world, making mortgage traders, particularly Salomon's mortgage traders, extremely powerful.

The **corporate finance group** advised corporations on financing needs and strategies for raising new equity. Relationships were generally long term and between Salomon's client relationship managers and the clients' Chief Financial Officers. Members of the corporate finance group were notably different from members of other groups within Salomon, particularly traders. They each had a big glass office, a secretary, a large expense account, and lots of meetings with captains of industry.[51] The group serviced the corporations and governments that borrow money.

The men from **equities** were considered second-class citizens because, comparatively speaking, equities made no money.[52] Even so, Salomon Brothers was the leading underwriter of new stock issues on Wall Street and one of the two or three top equity traders. The equity department was on the 40th floor, below trading, served by a different bank of elevators than other Salomon departments.

6. Emerging subcultures

Salomon's rapid growth—hundreds of new MBAs hired every year, along with support staff—created new stresses on the system. According to insiders, "nothing bound [these new employees] to the firm, except money and a strange belief that no other jobs in the world were worth doing. There were no deep and abiding loyalties to Salomon Brothers."[53] Seemingly in support of this view, within three years, 75% of this new class left "the Brothers," compared with previous years when after three years, an average of 85% of the class was still with the firm.[54]

The Salomon culture of the 1980's fostered money-making, risk-taking elitism and territorialism. Groups felt little or no affinity with other Salomon units. To the high-flying traders, corporate financiers were considered "wimps," because they didn't risk money.[55]

The arb group in particular felt that Salomon was holding them back and that they were subsidizing the rest of the firm. Members complained about the firm's excesses, the lackluster performance of many of its businesses, and Gutfreund's weak management.[56] To protect the group's competitive edge, members were highly secretive about strategy and earnings.[57] And senior management fostered this elitism. "Arbs" were promoted more quickly than others at Salomon. "Meriwether developed his own customized analytical systems with personal computers, while other departments had to work through a central mainframe computer."[58]

Further exacerbating intra-group hostilities was the fact that the mortgage department had a culture all its own--one based on food and practical jokes. For instance, each Friday was "Food Frenzy" day, during which all trading ceased while enormous amounts of food were consumed. The group's motto was, "we don't work for Salomon Brothers, we work for the mortgage department."[59] Ranieri preserved this culture by hosting events from which government and corporate traders were strictly prohibited.

The mortgage group met with increasing hostility from other departments within the firm, particularly the corporate and government bond trading units, led by Bill Voute and Tom Strauss, respectively.

The upshot of the hostilities between the mortgage department and the two other powers of Salomon, corporate and government bond trading, was that everything in the mortgage department became separate: mortgage sales, mortgage finance, mortgage research, mortgage operations, and mortgage trading.[60]

According to Ranieri, "The reason everything was separate was because no one in the firm would help us. They wanted us to fail."[61]

Contentious Compensation

At the end of each year the people on the Salomon trading floor also became occupied with "trading their careers."[62] This was because year-end bonuses were not tied directly to one's profitability but rather to the perception of one's value by the Salomon Brothers compensation committee, which was headed by Gutfreund. At Salomon, total compensation for non-managing directors averaged along the lines of 40% base salary and 60% bonus.[63] The 139 managing directors (approximately 2% of the firm's employees) could earn up to $150,000 in salary and well over $1 million in bonus. The process of determining bonuses was often contested and was frequently described as "political," too centralized, and not dependent enough on clear criteria.[64]

Consequently, although no one's total pay was permitted to drop more than 20% from year to year, year-end bonuses were highly subjective.[65] This constant upward pressure on a firm's compensation expense was less of a concern during the intense growth of the early 1980s, but in 1986 and 1987 when revenues and profits declined, the pressure to maintain high compensation levels remained.[66]

After the Phillips merger, the partnership arrangement was dissolved. Therefore, when the new generation of traders produced millions for the firm, they demanded a percentage of the millions that they made for the company. Gutfreund had no intention of paying anyone "a cut." In a 1985 *Business Week* interview, Gutfreund openly criticized what he termed the considerable greed of the younger generation.[67] He told the reporter, "I don't understand what goes on inside their pointy little heads."[68]

The inability of Salomon management to solve this compensation issue caused traders and senior executives to leave the company in ever increasing numbers. This was particularly true with mortgage traders, who had made a fortune for Salomon Brothers in 1984, while the firm as a whole had not done well. The competition was willing to pay them million dollar plus salaries, whereas Gutfreund was not.

The traders who left Salomon provided the competition not only with trading skills and market understanding, but also with a complete list of Salomon Brothers' clients. It is estimated that the transfer of skills and information cost Salomon hundreds of millions of dollars. By allowing Salomon mortgage traders to leave and work for the competition, Salomon Brothers "let slip

through its fingers the rarest and most valuable asset a Wall Street firm can possess: a monopoly."[69]

Monitoring Costs

Salomon Brothers was the only major firm on Wall Street in the early 1980s with no system for allocating costs. This made budgeting and planning impossible, and gave unit heads license to spend whatever they could to build revenues. No measure was taken of the bottom line; people were judged by the sum total of the revenues on their trading books irrespective of what costs were incurred to generate those revenues. Revenue, not profits, brought glory and advancement. Gross revenues meant power.[70]

Costs were most out of control in the mortgage department, the place were there had been so much revenue. Many mortgage traders felt that since they were underpaid--and Ranieri agreed with this assessment-- the Salomon Brothers' expense account could be used to supplement their income. "We'd lend our telephone charge cards out to friends...people would use Salomon limos to take their wives shopping on the weekends."[71] In 1986, Salomon's expenses increased 40%.

7. The Revlon Assault, Black Monday, and Retrenching

In the Fall of 1987, Ronald O. Perelman, head of Revlon Inc., made an unsolicited hostile bid for Salomon, backed by Drexel Burnham Lambert Inc. It was the first time Wall Street had turned and attacked its own.[72]

The most frequently cited explanation was that Perelman's true backer, Michael Milken, was taking revenge on Gutfreund. In early 1985, Milken went to Salomon's offices for a breakfast meeting with Gutfreund, and became angry when Gutfreund refused to speak to him as an equal. The meeting ended in a shouting match, with Milken being escorted from the building by security. Gutfreund then excluded Drexel from all Salomon Brothers bond deals.[73]

A year-and-a-half later, Drexel was offering to purchase 25% of Salomon's stock for Perelman, and effectively seize control from Gutfreund.

Taking action, Gutfreund found a friendly buyer to purchase the shares in question. He turned to an old friend of his, Warren E. Buffett, the chairman of Berkshire Hathaway Inc., and sold him $700 million in newly created convertible preferred stock, using the proceeds to buy the common stock Mr. Perelman had targeted. Not only did the stock pay 9% interest, it could be converted into common stock for $38 a share at anytime before 1996.[74] The result of the deal was that Buffett had little risk but a huge potential profit. Salomon, on the other hand, was left with $109 million less in capital and an annual bill of $63 million for the dividends on Buffett's stock.

Another explanation for Perelman's takeover attempt was that Milken smelled blood. He may have seen what John Gutfreund knew, that Salomon's bottom line and management structure were in trouble. In late 1986 Gutfreund established a new Office of the Chairman (OOC) in order to streamline decision-making.

It quickly became known that the Office of the Chairman was divisive. In essence it was a continuation of the battle between the three debt departments, with Tom Strauss representing the government department, Bill Voute representing the corporate department, and Ranieri representing the mortgage department.[75] Strauss and Voute had Ranieri fired in 1987, and the mortgage department was eventually shut down.

In response to the takeover bid and Buffett's new interest in the company, task forces were created to evaluate which businesses were profitable and what to include in each business's strategic plan. In this review process, Salomon was shocked to learn that its workforce had increased by 40% between January 1986 and June 1987.

The board decided that Salomon, the nation's largest underwriter of municipal securities would leave the municipal business, and would also vacate the commercial paper business, which dealt in short-term corporate securities. The firm's head count would be cut by 12%, both in numbers of employees and dollars.[76]

On October 12, 1987, the *New York Times* reported that the firm was planning to fire 1,000 people. The news was completely unexpected by members of the company. Although employees were aware that a review of Salomon's businesses was underway, they had been assured that everyone's job was safe.

That afternoon, two entire departments on the 41st floor, municipal bonds and money markets, were eliminated; 800 jobs were lost. Gutfreund told the press and his employees that he had intended to move carefully in determining who should be laid off. However, he felt that once the story hit the papers, he had been forced to take quick action. It is still unclear who leaked the story since Salomon employees believe it is a cardinal sin to speak to the press.

Black Monday

When the stock market fell 508 points on October 19, 1987, Salomon Brothers lost $75 million in after-tax earnings for the month.[77] The firm's losses could have been mitigated, however, by the fact that investors were taking money out of equities and putting it into the money markets. Had Salomon maintained their money market department, they could have taken advantage of this windfall. The decline in business after the crash occurred mainly in the equity markets. The one and only department that Salomon did not restructure was its equity department. In fact, the one glaring loss by Salomon occurred because the firm had agreed to purchase 31.5% of British Petroleum from the British government and remarket the shares worldwide. Salomon lost more than $100 million on the BP deal.

By the time the dust settled on 1987, Salomon had suffered its worst earnings performance of the decade, earning only $142 million, a 3.7% return on equity.[78] The firm experienced flat or declining revenues in many of its businesses. Compensation expenses had risen tremendously. *The New York Times* wrote on January 10, 1988, "Salomon became a glaring corporate victim of Wall Street's extended mad rush to expand."[79]

Taking out scissors

As a result of the firm's 1987 losses, bonuses of top executives were cut. It was the first year since Salomon became public that bonuses actually declined. Gutfreund led the way by opting not to take a bonus at all. Instead, he received his $300,000 annual salary, plus $800,000 of cash deferred from 1984. However, in lieu of a bonus, he received 300,000 options for Salomon stock.[80]

In an effort to pare down Salomon's costs, Gutfreund appointed Don Howard, Citicorp's former Chief Financial Officer, to be the firm's CFO in 1988. Under his leadership a business unit approach was instituted, where each unit would be responsible for its own financial support and systems development people. Each unit submitted its budgets, business analysis reports, and business plans to the OOC. Forecasts of significant changes affecting business and the unit's anticipated performance were required every six months.

Management also developed new financial systems to calculate profits for the new, complex products that the firm offered. A new revenue measurement system was defined to help senior management assess which businesses were profitable and where to allocate resources.

Management fired or forced resignations of hundreds of accountants, computer programmers, and other back-office technicians. This staff had provided an effective counterbalance to the firm's excesses of the 1980s. It had slowed some of the firm's growth and proliferation of new products because support was unable to keep up. In a routine audit, it had discovered that Salomon owned an interest in one of the largest brothels in Manila, the Philippines.[81]

At the same time, Salomon management determined that new offices were needed to accommodate the increased staff. The firm began construction of the biggest, most expensive real estate project to date in Manhattan, but eventually discontinued the project at a cost of $107 million.

Retreating

The company's financial position continued to decline in 1988. Salomon's net income was $280 million for the year. In reaction to Salomon's steady decline, Gutfreund admitted that fundamental changes should be instituted within the firm. He admitted that he and his executives had been slow to react to changes in the industry. He said, "the world changed in some fundamental ways, and most of us were not on top of it. We were dragged into the modern world."[82]

Attempt to retain arbitrage group

Salomon's abitrage group was generating increasingly larger proportions of Salomon's profits in 1989 and 1990. Keeping the arbitrage traders happy and in the Salomon fold became imperative for Salomon's survival. In 1990 Gutfreund made a deal with the "arb" group to increase the salaries of its traders. The corporate and government traders were not included in this arrangement. Salomon etiquette had been violated. Historically, traders, regardless of function, have been compensated similarly, be they treasury or mortgage traders.

A single [agreement] had thrown into doubt not only the compensation system but also the longstanding pecking order within Salomon Brothers. Money was the absolute measure of one’s value to the firm. Paying a mortgage trader much more than a treasury trader made the treasury trader feel unwanted.[83]

8. Return to the Scene of the Crime

By February 1991, Paul Mozer was already well known at the U.S. Treasury for his on-going battles over Treasury auction rules. He fought relentlessly to squeeze advantage out of the system, seeking ways to leverage Salomon’s still substantial capital advantages.

Treasury rules prohibited a bidder at a Treasury auction from purchasing more than 35% of the total amount of the securities available. Before 1990, a bidder might decide to submit a bid for more than 35% to increase its chances of being awarded the 35% maximum purchase amount in the event of proration--the process by which auction securities are divided proportionately among all bids at the highest yield accepted at the auction.

In a July 1990 auction Mozer submitted a bid well in excess of 100% of the amount of bonds being auctioned, apparently in the hope of guaranteeing the maximum 35% purchase award for Salomon after proration. The Treasury viewed Mr. Mozer’s conduct as inappropriate and rejected Salomon’s bid.

Treasury subsequently ruled it would no longer recognize any bid amounts by a single bidder at any one yield level in excess of 35% of the offered securities.

Paul Mozer was publicly critical of both the Treasury’s new 35% bid-limit rule and the Treasury’s actions in adopting the new rule without first consulting with primary dealers. He was especially critical of Michael Basham, Deputy Assistant Treasury Secretary for Federal Finance, who supervised auctions at the Treasury, and the new 35% bid-limit rule became known to many on Wall Street as the “Mozer/Basham” rule.

Interestingly, Paul Mozer’s illegal bidding activity increased greatly after Gutfreund’s compensation deal with the arbitrage traders became known. As a treasury trader, he perceived more power to the arbitrage group as a threat to his group’s status. He submitted two bids in late December 1990, just a few days after learning of the arbitrage deal. He did it again on February 7.

And on February 21, 1991, Mozer submitted three separate bids for the U.S. Treasury’s $9 billion 5-year treasury note auction, each the maximum 35% from any single bidder, unaware that S.G. Warburg, the client whose name he was using to front one of his fraudulent bids, was simultaneously submitting its own bid in the same auction, for 1% of the offering.

Salomon’s control system should have detected Mozer’s illegal trading activity by sending confirmations of trades to the clients in whose name they were made. A copy should have been sent to the salesmen responsible for those clients. And the trades should have shown up in internal sales reports. Mozer was able to avoid detection because Salomon’s technology

modernization program in the 1980s had become captive to the heads of its various operations, who were more concerned with controlling costs than having close scrutiny of their actions.[84]

9. Salomon's Fall

The day after the auction took place, Feb. 22, 1991, a representative of the Federal Reserve contacted Salomon's Government Trading Desk to inquire about the "Warburg" bid. Thomas Murphy--who was also a Managing Director and assistant to Mozer--advised the government official that the bid had mistakenly been submitted in the name of "Warburg" and should have been submitted in the name of Mercury Asset Management, an affiliate of S.G. Warburg & Co.

On April 17, 1991, the Treasury sent a letter addressed to Charles Jackson, a Senior Director of Mercury, reviewing S.G. Warburg's legitimate $100 million, 1% bid and the "Mercury" bid submitted by Mozer for $3.15 billion, or 35%.[85] The Treasury also sent copies of this letter to Mozer as well as to a representative of the Federal Reserve. The Treasury letter advised Mercury that, in the future, bids submitted by all subsidiaries of S.G. Warburg, including Mercury, would be treated as a bid from a single entity for purposes of the Treasury's 35% bid-limit rule.

When Paul Mozer received the letter, he apparently became concerned that the Treasury would learn from Mercury or S.G. Warburg representatives that neither of those entities had authorized Salomon's initial submission of a bid in "Warburg's" name, or its subsequent use of "Mercury" to identify the bid. Mozer contacted Charles Jackson of Mercury and told him that Salomon had mistakenly submitted a bid in Mercury's name in the February 21 auction. Mozer requested that Mr. Jackson not embarrass Mozer with the Treasury and the Federal Reserve by responding to the Treasury's letter. The letter itself did not ask for a response. Mozer also asked Nick Ritchie, Salomon's customer contact at Mercury, not to voluntarily report Salomon's "error" to the Treasury.

In late April 1991, Mozer showed his supervisor, John W. Meriwether, Vice Chairman of Salomon, the Treasury's April 17 letter and admitted that he had submitted an unauthorized bid. Meriwether asked whether unauthorized customer bids had been submitted on other occasions. Mozer said this was the only unauthorized bid intentionally submitted by the Government Trading Desk—a statement which was far from true. He failed to mention, amid others, his bid submitted in the name of "Quantum" in the same February 21 auction. In reality, Mozer's February bid had been part of "a pattern of fraudulent conduct"[86] that continued even after he admitted it to his superiors. Meriwether told Mozer the matter would have to go to the attention of Thomas W. Strauss, Salomon's President.

Strauss, Meriwether and Donald M. Feuerstein, Salomon's Chief Legal Officer, informed John Gutfreund later that week that Paul Mozer had admitted falsifying a customer's bid during an auction of five-year Treasury notes.

During this meeting the topic of terminating Mozer was never discussed. Nor did the participants discuss whether Salomon should institute changes to guard against similar mistakes in the future. Instead, Meriwether defended Mozer, claiming that he had made a mistake. They decided that

Mr. Mozer's conduct should be reported to government authorities and they discussed how this should be done.

However, according to a statement issued by Salomon, "due to a lack of sufficient attention to the matter, this determination was not implemented promptly."[87] In fact, no final decision was made concerning the manner in which the matter would be reported to governmental authorities. Consequently, the four senior executives did not report Mozer's activities to the Federal Reserve Bank until August 1991, four months later.

As a result of their delayed action on the revelations about Mozer's fraudulent bond trading, Messrs. Gutfreund, Strauss, and Meriwether resigned from their positions at Salomon. Mr. Mozer was fired. Months of government investigation followed and ultimately, Salomon agreed to pay $290 million for its actions, although it avoided criminal charges.[88]

At the press conference in which he announced he was leaving the firm where he had worked for 38 years, Mr. Gutfreund was asked if he was sorry. He responded, "Apologies are bullshit."[89]

Aftermath

Majority stockholder Warren Buffett was brought in to replace Gutfreund and perform damage control. Buffett ultimately rescued the company from disaster when the U.S. Treasury banned Salomon from bidding in government securities auctions. Buffett's efforts convinced the Treasury that the ban would force Salomon to file for bankruptcy, which would have "domino effects that would reach worldwide" due to the company's $130 billion in short-term debt. The Treasury rescinded the ban. After Salomon agreed to and paid its $290 million fine, the U.S. Federal Reserve Bank of New York announced its decision to retain Salomon Brothers' designation as a primary dealer.

In the years following the scandal, many Wall Street firms fared poorly due to weak markets and lower trading and underwriting activity. Salomon, though, was particularly hard hit due to its heavy dependence on trading. Since 1994, when trading losses amounted to $399 million, Salomon lost considerable ground. "In the five years it took for them to find their stride, their competitors have moved to the next level,'" said analyst Peter Russ of Shelby Cullom, Davis & Co.[90]

Today, you can find the Salomon name attached to Smith-Barney. The meaning of the Salomon name, at one time one of the largest and most agile trading firms ever to stride Wall Street, is gone.

Endnotes

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[44] Peter Grant and Marcia Parker, "Hurtling Toward Scandal," *Crain's New York Business*, June 1-7, 1992, p. 9.
[45] Ibid.
[46] Ibid., p. 10.
[47] Michael Lewis, *Liar's Poker* (New York: W.W. Norton & Co., 1989), p. 15.
[48] Peter Grant and Marcia Parker, "Hurtling Toward Scandal," *Crain's New York Business*, June 1-7, 1992, p. 10.
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