Promoting and Protecting Shareholder Interests

It has never been more evident that business leaders must hold themselves and their companies to the highest ethical and business standards. Only by putting appropriate corporate governance mechanisms in place, and otherwise aligning the interests of management with shareholders, will shareholder interests be adequately promoted and protected. The discussion below is intended to inform our shareholders and other interested parties about our philosophy and actions in this important area. Further information concerning our corporate governance structures is contained in our 2003 Proxy Statement and on our Web site.

On May 7, 1999, Goldman Sachs became a public company — a profound change for the firm. Operating as a partnership for 130 years, it had successfully evolved from its roots as a modest, family-owned business founded in 1869, into one of the most prominent investment banking, securities and investment management firms in the world.

In making the transition to a public company, we were determined to retain the best characteristics of the partnership culture that had led to our success — a key element of which is meaningful ownership of the firm by its people. A major priority was putting in place a strong framework of governance and assembling a Board of Directors that would promote and protect the interests of our new partners, our public shareholders.

RETAINING THE STRENGTHS OF AN OWNER CULTURE

The core of the Goldman Sachs partnership was shared long-term ownership. It shaped individual behavior and our approach to business. The partners were the owners of the enterprise and, with few exceptions, they could not withdraw their capital until they left the firm or retired. Their interests were tied individually and collectively to the well being of the firm as a whole.

As a result, there was a total alignment between ownership and management because they were one and the same. The leaders of virtually every business were partners with their capital tied up in the firm. We are in a business where our success is in large measure a reflection of our people and our reputation. Every partner had a tangible interest in strong operational and legal and ethical controls, effective risk management methodologies and maintaining a culture of integrity. In that regard, we rigorously adhered to mark-to-market accounting to ensure that our recorded positions reflected economic reality. And they had to because our accounting formed the basis for determining partners' individual capital accounts and paying them out when they retired from the firm.

We viewed our public offering as an opportunity to deepen the benefits of ownership by sharing it with all of our people. So we made the largest stock grant to employees in history. Approximately $5 billion of Goldman Sachs stock was distributed to all of our employees, at all levels in the firm. We believed that by making all of our people owners, the firm would benefit by strengthening the culture of ownership.

We also took steps to ensure that our people would retain an important personal stake in Goldman Sachs going forward. First, we established minimum stock retention requirements for all of our Managing Directors (currently over 1,000 individuals) based upon the shares they received at the time of the IPO and subsequently as a portion of their annual compensation. Today, virtually all of our senior executives have the largest part of their personal assets in Goldman Sachs stock. Their financial success is directly tied to the success of Goldman Sachs. We also established compensation plans in which a significant portion of compensation — approximately 45% for our most highly paid people — is in the form of equity. Today, Goldman Sachs is distinctive among large public companies in that a very significant portion of the firm (over one-third) is owned by its people.

Another key element in retaining the best aspects of our partnership culture was the establishment of a partnership compensation plan. Every two years, we elect new partners. Those partners, who currently number about 290, are compensated by their share of a compensation pool, which is determined each year by the firm's overall level of profitability. The effect of this concept is that our most senior managers' compensation is directly linked to the success of the firm as a whole. This is a unique approach to compensation in our industry and it encourages the firm's leaders not to focus narrowly on their individual businesses, but rather to work together to maximize the success of Goldman Sachs.

At the time of the IPO, the firm was owned principally by partners who were engaged full-time in the business. A smaller portion was also held by retired partners and certain institutions. We viewed a major challenge of our transition to a public company to be the orderly distribution of a significant portion of these shares into the public market, with as little disruption as possible, so as to eliminate the market "overhang" issue and to provide deep liquidity for our public shareholders. With the exception of the three most senior officers, we have encouraged our partners to sell a portion of their shares on an orderly and volume-limited basis. Last year, after we reached approximately 50% public ownership, Goldman Sachs was added to the S&P 500, perhaps the most significant index for listed shares in the U.S., and an important milestone for any company, given how many investors use it as a benchmark.

THE FRAMEWORK FOR GOVERNANCE: MANAGEMENT AND THE BOARD

The leadership and oversight task for an investment bank like Goldman Sachs is a complex one. We are one of a handful of truly global investment banks conducting advisory, asset management and securities sales and trading businesses around the world, and are active in virtually every market center. We manage considerable risk, often taking on large capital commitments, on short notice. Senior management must spend considerable time with clients. Our industry is highly regulated, and here again, the global nature of the enterprise adds to the complexity since every jurisdiction has its own regulatory regime or regimes.

The partners of Goldman Sachs, prior to the IPO, delegated oversight and firmwide decision making to a Management Committee, comprised of the Senior Partner and a group of senior business leaders who brought their individual skills, technical knowledge and experience to bear collectively on the major issues facing Goldman Sachs. As a public company, management is vested in the CEO and other senior business leaders, with a firmwide Management Committee continuing to assist in the overall leadership and direction of the firm.

We believe that in view of the complex nature of our business, the shareholders of Goldman Sachs benefit by having a number of Management directors — who literally know the firm from inside out — engaged together with the outside directors in the Board of Directors' oversight role. We also recognize that from a governance perspective, it is important that there be a substantial majority of outside directors on our Board.

At the time of the IPO, Goldman Sachs' Board of Directors was comprised of seven members, five of whom were inside directors and two of whom were outside directors. A commitment was made to achieve a majority of outside directors within three to five years, which commitment was satisfied in October 2001. We currently have five independent outside directors and four members of Management on our Board. We will continue to add outstanding non-Management directors selectively and over time.

Our outside directors are first-rate, proven leaders in their fields who have the character, confidence and expertise to be tough-minded and independent. They are all experienced directors of public companies and successful leaders of complex organizations whose complementary backgrounds, experiences and skills make the Board, as a whole, highly effective. The interplay of the directors' diverse perspectives has been invaluable to our successful evolution as a public company and will be vital to our continued success. To align their interests more fully with shareholders, the compensation of our outside directors has been paid predominantly in equity of Goldman Sachs, and they receive no fees from the firm except those paid for their Board service.

THE FRAMEWORK OF GOVERNANCE: ROLES AND RESPONSIBILITIES

The Board of Directors oversees the development of our strategy and performance of our businesses and Management. Management is responsible for presenting strategic plans to the Board for review and approval and for implementing the firm's strategy. Among the Board's most important functions are the selection of its Chairman and the firm's Chief Executive Officer. The Board does not have a policy on whether the role of the Chairman and CEO should be separate or combined but believes that the current combined arrangement serves Goldman Sachs well at this time. Other significant Board functions, certain of which are conducted with the assistance of one of its three committees described below, include oversight of the integrity of our financial statements, compliance with laws and regulations and risk management, evaluation of the CEO, review of management succession, director compensation, and the review and approval of significant transactions.

Our directors are expected to be, and they are, active overseers of our business. In addition to the minimum of five formal board meetings (and the committee meetings described below) to be held each year, the directors are solicited for, and at their own initiative provide, their views and counsel on a variety of topics.

Our non-Management directors meet periodically in executive session. Unless they determine otherwise, the Chairman of our Corporate Governance and Nominating Committee presides at these meetings. The meetings provide a forum for the free expression of views and the exchange of ideas by our outside directors without the possible inhibiting influence of Management directors.

The Board of Directors accomplishes a substantial amount of its work through three committees: the Audit Committee, the Compensation Committee and the Corporate Governance and Nominating Committee. Our Corporate Governance Guidelines and committee charters require that all members of these committees be "independent"—that they have no relationship that may interfere with the exercise of their independence from Management and the firm. Each of these committees is authorized to engage whatever resources, as it deems appropriate, without seeking approval of the Board or Management, to discharge its duties and responsibilities. Our strong belief is that exceptional independent oversight will promote and protect shareholder interests.

Our Audit Committee consists of four independent directors and is chaired by Lord Browne of Madingley, who is the Group Chief Executive of BP p.l.c., and earlier in his career had been the Group Treasurer of BP and Chief Financial Officer of Standard Oil Company (Ohio). The primary purposes of the Audit Committee include assisting the Board in its oversight of the integrity of our financial statements, our compliance with legal and regulatory requirements, the qualifications and independence of our independent auditors, the performance of our internal audit function and independent auditors, and our management of market, credit, liquidity and other financial and operational risks. In addition, the Audit Committee reviews and monitors the adequacy of the structures, policies and procedures that the firm has developed to assure the integrity of our investment research. During fiscal 2002, the Audit Committee (or sub-committees thereof) held eight meetings, including five executive sessions, two private sessions with Management, and five private sessions with each of the independent auditors and Director of Internal Audit. Lord Browne also held five meetings with the Director of Internal Audit. The independent auditors and the Director of Internal Audit each have free access to the Audit Committee to discuss any matters they deem appropriate.

Our Compensation Committee consists of five independent directors and is chaired by James A. Johnson, a Vice Chairman of Perseus, L.L.C., a merchant banking and private equity firm, and retired Chairman and CEO of Fannie Mae. The primary purposes of the Compensation Committee include assisting the Board in overseeing the development and administration of our compensation programs and reviewing the compensation of our executives and, to insure consistency with the firm's Statement of Investment Research Principles, of our investment research professionals, and the development, implementation and effectiveness of our policies and strategies relating to human capital management. In particular, the Compensation Committee, after reviewing in detail our CEO's performance and taking into consideration an evaluation by the Corporate Governance and Nominating Committee, sets the CEO's compensation. In consultation with the CEO, the Committee also determines the compensation of all of our senior officers. In a service business, we know that without attracting and retaining the best people, we cannot be the best firm. Appropriate compensation and human capital management programs are crucial to success in this area. During fiscal 2002, our Compensation Committee held four meetings. In addition, Mr. Johnson met with the chairs of our internal compensation policy committee five times.

In September 2002, we formed our Corporate Governance and Nominating Committee, which consists of all five of our outside independent directors and is chaired by John H. Bryan, the retired Chairman and CEO of Sara Lee Corporation. The primary purposes of the Corporate Governance and Nominating Committee are to recommend individuals to the Board for nomination, election or appointment as members of the Board or its committees and to take a leadership role in shaping the corporate governance of Goldman Sachs, including developing and recommending to the Board and reviewing on an ongoing basis the corporate governance principles and practices it should apply to the firm. The Corporate Governance and Nominating Committee played a central role in developing our Corporate Governance Guidelines and our Code of Business Conduct and Ethics which applies to all of our directors and the people of Goldman Sachs worldwide. The guidelines and code were adopted by the Board in February of this year and are available on our Web site. Since its formation, among its other activities, the Committee has conducted an evaluation of the performance of the Board and of our CEO and reviewed the CEO's management succession plan. The Committee also has led the continuing search for individuals who possess the exceptional qualities necessary to be recommended for Board membership. Our newest outside director, William George, the retired Chairman and CEO of Medtronic, Inc., and director nominee Lloyd Blankfein, a Vice Chairman of the firm with responsibility for our securities businesses, were initially reviewed by the Committee. Since its inception, the Corporate Governance and Nominating Committee has held three meetings.

CREATING LONG-TERM VALUE FOR SHAREHOLDERS

One thing that has not changed since becoming a public company is our focus on creating long-term value for our owners, the only difference being that, today, our owners are no longer our partners, but our shareholders. As a public company we have worked hard to retain the elements of our partnership culture that led to Goldman Sachs' success. We have also focused on the new elements unique to public companies: creating a world class Board of Directors and a strong framework of corporate governance. Although our history as a public company is less than four years, we believe that we are off to a good start. However, we have also learned over the past 133 years that we can never be complacent. Our Management and our Board of Directors understand this and will always work to ensure the success of Goldman Sachs for the benefit of our owners.