SEC versus Goldman Sachs

The SEC alleges that:

- GS failed to disclose that Paulson was involved in the portfolio construction of ABACUS 2007-AC1.
- GS misrepresented to ACA that Paulson was 200m long in the equity of ABACUS 2007-AC1.
- GS entered into CDS with Paulson that allowed Paulson to buy protection on tranches of ABACUS 2007-AC1s' capital structure but did not disclose this to investors

The deal closed 2007 04 26. By 2007 10 24 83% of the RMBS had been downgraded and 17% were on negative watch. By 2008 01 29, 99% of the portfolio had been downgraded.

ABACUS 2007-AC1 was a synthetic CDO. Its assets consisted not of RMBS but of CDS referencing RMBS. In the construction of the collateral portfolio ABACUS 2007-AC1 would have to enter into these CDS with counterparties. Was Paulson a counterparty, the major or only counterparty?

It is going to be hard for the SEC to establish that GS defrauded investors by its failure to disclose Paulson's role and intentions in ABACUS. Why? Paulson wanted to make a bet. A bet is not a sure thing. If Paulson or GS could affect the outcome of the bet then that is another matter. GS was effectively Paulson's agent. GS got paid 15m to do the deal. GS job for which they were paid was to go find someone who would take the other side of the bet. GS is not bound to tell the other parties who their opposite number was. GS is indeed bound to provide full disclosure of the nature of the bet which they appear to have done. In fact, GS had a fiduciary duty to Paulson who was the paying client, a duty which includes confidentiality. One could argue that GS had a tortuous duty of care to the investors in ABACUS. Certainly there were conflicts. However, these are most certainly

circumvented by the fact that IKB and ACA were market counterparties or expert and professional investors. If each party acted with due care as fiduciaries it is hard to obtain a fraud. Paulson acted for his investors. Goldman acted for Paulson and for its own shareholders. ACA and IKB all acted for their shareholders. But a bet was made and there would always be winners and losers. If anything, the quality of due diligence of ACA and IKB and the ratings agencies should be questioned.

ACA was engaged to provide an extra set of eyes on the deal. They were engaged by GS as portfolio selection agent, as well as to provide the credibility necessary to distribute the deal. It appears that ACA Capital, ACA's parent turned up to effectively underwrite the deal as well. The SEC alleges that Paulson was involved in influencing the portfolio. This is trivially true by construction, however, things are not as clear cut as that. Paulson was specifying the bets he was willing to make. Out of the 123 underlying RMBS, ACA admitted 55. The final pool had circa 80 – 90 reference credits. ACA was not compelled to take the bets, and indeed only selected a subset of the Paulson portfolio. If we accept the SEC's point of view we are accepting as logical behaviour the turning down or accepting of a bet based on the counterparty and not the information about the prospects, outcomes and probabilities of the bet itself.

The fact that the deal would not have placed without ACA as an independent portfolio selection agent, that Paulson had a hand in the portfolio selection, that Paulson made lots of money, are immaterial to the allegation. They are, however, the realities of the industry.

Did GS's failure to disclose Paulson's position long or short, constitute fraud, is the question before the courts.

There is the second allegation that is as important if not more. In my mind, this is the SEC's stronger allegation since

the misrepresentation leads to fraud. This is the allegation that GS represented to ACA that Paulson would invest 200m in the equity of ABACUS 2007-AC1. The SEC complaint does not present supporting evidence. It is possible that the evidence exists, however, they have not referred to in the formal complaint at this time. For the time being what they have in the complaint seems to indicate that ACA assumed that Paulson would be long the equity, and GS simply failed to correct them. If so, it was a costly assumption for ACA and their parent.

Why might ACA assume that Paulson was long equity? The Paulson trade resembles a more common and widely executed trade which attempted to profit regardless of the direction of credit spreads in the reference portfolio. The Magnetar trades were of this nature. The trade involves being long the equity or junior tranche of the cap structure while being short the mezz or senior tranche of the cap structure on a delta neutral basis. This trade generates profits if spreads widen or tighten. How? The equity tranche is convex to spread widening. The more senior tranches are relative concave to spread widening. By delta hedging a long equity (convex) position with a short mezz (concave or negatively convex) position, the convexity of the bundle can be very pronounced leading to a long spread volatility position. As this was a common trade at the time, ACA might reasonably assume that the Paulson was attempting the same trade. It appears not, and that Paulson did not have a long equity position against the short mezz. It was in fact an unhedged and highly speculative trade for Paulson and one which could have gone wrong with serious results. ACA had probably assumed more sophistication on the part of Paulson than was the case. Paulson was no expert in structured credit. His background was in risk arb, a very specific hedge fund strategy. Betting on mortgages was a macro call. Using structured credit instruments to leverage this bet was arguably reckless. Fortune shone on Paulson and his bet paid off.

Guilty or innocent, GS has already been condemned by the public. Investor forums are replete with condemnations of Goldman the Vampire Squid. That much is clear. Whether this is justified or not is another matter which is not so clear.

The constructive fraud issue I think is unfounded and in any case will be very hard to prove. The related misrepresentation issue will imply fraud and boils down to the evidence, which has yet to be presented definitively by the SEC.

The lesson in all this is clear. Caveat emptor. What kind of investor are you? In the context of Poker, if you play the hand, then all you are concerned with are the details of the deal. If you play the player then it is your job to find out all about who you are playing against. And do your own homework. Quite how some of the CDO liabilities got rated AAA is a mystery to me. The speed at which the underlying collateral and the tranches were downgraded certainly calls into question the quality and value of credit ratings agencies judgment.

If the SEC is successful in its complaint, it will certainly open a can of worms. Lets just look in one narrow area, retail structured products. See all those retail structured products which are offered by private banks? Some of them are constructed with the needs of the investor in mind, but some of them are constructed because someone wanted to make a bet, and the other side of the deal needed to be found. Look at the disclosure in a structured product. Are you told who designed it? Who had a hand in designing it? Who is on the other side of the trade? Was it initiated by the structurer or their client? How many private investors would even dream of asking these questions?

There is a more interesting although less likely scenario.

Say that the SEC wanted to prosecute Paulson. Why is not important. Say the SEC has no proof. A formal complaint would

go nowhere and there would be a risk of a libel countersuit, or a frivolous litigation countersuit.

The SEC might decide that it has a case against GS in a related capacity, that of a conflicted agent. The case is thin but it would allow the SEC to bring allegations against Paulson, that it cannot substantiate, with immunity from libel prosection in the course of prosecuting its case against Goldman.

This is of course mere speculation.