



**The United States Securities
and Exchange Commission**

v.

**Goldman, Sachs & Co.
and Fabrice Tourre**

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and
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Cautionary Language

- At root, this litigation is about allegedly undisclosed allegiances and purportedly hidden incentives. I prefer not to compound the problem tonight.
- I am a co-founder and director of Financial Engines. Goldman Sachs was lead underwriter for Financial Engines' recent IPO. Some might think I have an incentive to curry favor with Goldman.
- I am also a former Commissioner of the Securities and Exchange Commission. Some might think I have an incentive to promote my former agency.
- You decide for yourself.
- This presentation speaks as of April 27, 2010. Additional information regarding this litigation is likely to emerge, and I reserve the right to change my views and analysis in light of additional information.
- The views expressed in this presentation are my own. They do not reflect the views of the Securities and Exchange Commission or of Goldman Sachs & Co. None of my views should be imputed to either the SEC or to Goldman Sachs.

Elements of the Commission's Causes of Action

- The Complaint alleges violations of Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, and of Section 17 of the Securities Act.
- To establish a 10b-5 violation the Commission must demonstrate: (1) a material misrepresentation or omission; (2) in connection with a purchase or sale of a security; (3) scienter; and (4) jurisdictional means.¹
- Private party plaintiffs must also demonstrate reliance and loss causation.² But, as discussed below, concepts of reliance and loss causation can and do bleed back into the analysis of materiality.
- For information to be material, “there must be a *substantial likelihood* that disclosure of the omitted fact *would* have been viewed by the *reasonable investor* as having *significantly altered the total mix* of information made available.”³

¹ SEC v. Hasho, 784 F.Supp 1059, 1106, 1110 (SDNY1992).

² Operating Local 459 v. Smith Barney Fund Management LLC, 595 F.3d 86, 92 (2nd Cir 2010).

³ TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

Elements of the Commission's Causes of Action

- Scienter describes “a state of mind embracing an intent to deceive.”
- The Second Circuit interprets scienter to include recklessness, defined as “highly unreasonable” conduct that “represents an extreme departure from the standards of ordinary care.”²
- The elements of the 17(a)(2) and (3) claims are “essentially the same” as in a 10b-5 action “though no showing of scienter is required for the SEC to obtain an injunction under subsections (a)(2) and (a)(3).” Negligence will suffice.³
- The large weight of opinion is that there is no private right of action under Section 17(a).

¹ Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193, note 12 (1976).

² SEC v. McNulty, 137 F.3d 732, 741 (2nd Cir. 1998).

³ SEC v. Espuelas, 2010 WL 1170665 (SDNY, March 26, 2010); Aaron v. SEC, 446 U.S. 680, 695-97 (1980).

The SEC's Allegations: Deception

- Goldman helped structure an investment that was designed to fail. Goldman lied or remained silent when it should have disclosed the truth about the investment. Even worse, it hawked this fatally flawed investment to its own clients who proceeded to lose hundreds of millions of dollars.
- Goldman knew it couldn't sell the transaction without the participation of a seemingly objective portfolio selection agent (Complaint at ¶21). It "will be important that we can use ACA's branding to help distribute the bonds." (Complaint at ¶23).
- Goldman knew it would be "difficult, if not impossible, to place the liabilities of a synthetic CDO if they disclosed to investors that a short investor, such as Paulson, played a significant role in the collateral selection process." (Complaint at ¶19).
- Goldman never disclosed to ACA that Paulson intended to go short, and deceived ACA by allowing it to believe that Paulson would have a long position in the transaction.
- Goldman never disclosed to its clients that Paulson had a short interest, or that Paulson participated in the portfolio selection process.

The SEC's Allegations: Materiality

- Eric Kolchinsky is a former employee of Moody's and for most of 2007 oversaw Moody's ratings of subprime CDOs.
- Senator Carl Levin asked Kolchinsky whether Moody's knew of Paulson's involvement in Abacus.
- Kolchinsky: "I did not know, and I suspect – I'm fairly sure that my staff did not know either."
- Senator Levin asked whether details of Paulson's involvement were "facts you or your staff would have wanted to know before rating Abacus."
- Kolchinsky: "Yes, that's something I personally would have wanted to know...it just changes the whole dynamic of the structure, where the person putting it together, choosing it, wants it to blow up."¹
- Paulson's financial interest and participation in the portfolio selection process is obviously material because it is inconsistent with the presentation of ACA as an objective, unbiased portfolio selection agent.

¹ Story, Louise, Chan Suell, and Gretchen Morgenson, "Goldman Sachs Messages Show it Thrived as Economy Fell," *New York Times*, April 24, 2010.

The SEC's Allegations: State of Mind

- Goldman knew its conduct was inappropriate:
 - It knew that the situation involving Paulson and ACA was “surreal.” (Cmplt. ¶32).
 - It knew that “the cdo biz is dead, we don’t have a lot of time left.” (Cmplt. ¶18).
 - Its own employees described these transactions as “complex, highly leveraged, exotic trades” that were “monstruosities!!!” [*sic*] created “without necessarily understanding all of the implications” of the transactions. (Cmplt. ¶18).

The SEC's Likely Strategy

- Keep the case as simple as possible. Stay away from the complexities of the synthetic CDO market, and from standard practices in that market.
- Try to emphasize a populist approach: who designs a product wanting it to lose value and then peddles it with the patina of legitimacy obtained only by fooling an intermediary like ACA and by not providing full disclosure to all purchasers?
- Of course, any buyer (and ACA and the rating agencies) would want to know about Paulson's involvement. Goldman clearly should have told them. It is only common sense.
- Senator Carl Levin: "To sell to customers at the same time you are betting against what you're selling – we think it's not uncommon and it ought to end."¹
- Senator John McCain: "I don't know if Goldman has done anything illegal" but "I doubt this behavior was ethical and the American people will render a judgment as well as the courts."²
- Senator Claire McCaskill: "It's gambling, pure and simple, raw gambling. You are the bookies, you are the house. You have less oversight than a pit boss in Las Vegas."³

¹ Harper, Christine, "Goldman Sachs Bet Against Its Own Deals, Senate's Levin Says," Bloomberg, April 26, 2010.

² Live Blogging the Senate Hearing on Goldman, New York Times, April 27, 2010 at 10:51 a.m.

³ Id.

Goldman's Defense

- We never lied to or deceived ACA or anyone else about;
 - Paulson's role in selecting the portfolio, or
 - Paulson's interest in being short in this transaction, or
 - Our own position in the transaction.
- Even if you mistakenly think there was a misrepresentation or omission, it was immaterial and is therefore not actionable.
- We were never negligent. Our practices were consistent with all legal requirements and industry standards. We most certainly did not act with scienter.
- We told our clients and they knew that we could be on the opposite side of the transaction. They also knew there had to be a large short on the opposite side of this transaction. We were actually long in this transaction and, like our clients, we lost money on this deal.

Goldman's Defense: No Deception

- Fabrice Tourre categorically rejects the Commission's allegations: "I never told ACA . . . that Paulson & Company would be an equity investor . . . I recall informing ACA that Paulson's fund was expected to buy credit protection on some tranches of the AC-1 transaction. This necessarily meant that Paulson was expected to take some exposure in the deal." "Quite frankly, I am surprised that ACA could have believed that the Paulson fund was an equity or long investor in the deal."¹
- Mr. Paolo Pellegrini, a former top executive at Paulson & Co. "told investigators from the [SEC] that he had informed ACA...that [Paulson] was betting against a transaction that is now at the center of the lawsuit."²
- The Complaint itself is very weakly worded. It never alleges that Goldman made any misrepresentation to ACA or to anyone else about Paulson's economic position. Instead, it speaks of the defendants as "responsible for ACA's misimpression that Paulson had a long position," (Complaint at ¶45) and of ACA having "been misled into believing" Paulson would be long. (Id. at ¶49). There is a difference between failing to correct a misimpression and lying.
- The Complaint nowhere alleges that ACA asked about Paulson's position or that Paulson or Goldman lied about Paulson's position.
- If there is a problem here, it is ACA's failure to ask the simple question in response to which we would not have lied (putting aside the fact that ACA knew of Paulson's position, because Pellegrini and Tourre informed them).
- Also, Paulson's intent was apparent to any knowledgeable person: if he was trying to find the worst Baa2 debt, that should have been entirely obvious to ACA, and it could not have been deceived.

¹ Testimony of Fabrice Tourre, Before the Permanent Committee on Investigations, United States Senate, April 27, 2010, at 2,3.

² Ng, Serena, and Gregory Zuckerman, "Questions Raised about U.S. Evidence on Goldman," *Wall Street Journal*, April 21, 2010.

Goldman's Defense: Immateriality

- The reference instruments were all rated Baa2, and virtually every Baa2 collapsed in the crisis. Paulson's involvement had no material effect on the portfolio's performance. All purchasers had accurate information about the composition of the reference portfolio. As subsequent events demonstrate, portfolio composition is the key piece of information necessary to form a view regarding the portfolio's performance. Paulson's participation is therefore again irrelevant.
- ACA exercised independent, professional judgment in structuring the portfolio. As the Complaint itself explains, ACA rejected many of the 123 instruments initially proposed by Paulson, found it had itself purchased 62 of the 123 names "at the same lower ratings" (¶27), and engaged in a vigorous iterative process before settling on the 90 names included in Abacus. IKB also provided input to ACA. ACA never abandoned its professional judgment.
- All purchasers were sophisticated and all knew that counterparties create offsetting long or short positions. The fact that an investor happens to be long or short on a particular instrument is thus immaterial as a description of their perspective regarding the market as a whole.
- Synthetic CDOs cannot even exist unless a seller goes short precisely the amount a purchaser goes long. The buyers therefore had to know that there was a large short in the market. The longs would be of the view that a subprime meltdown was unlikely, and the effects of the structure were fully priced.
- Even if some investors' positions in a single instrument might be viewed as material, as of 2007, Paulson was not then viewed as a particularly knowledgeable participant. Information about Paulson was therefore particularly irrelevant.
- If Professor Duffie's explanation is correct, and Paulson was trying to construct an investment that would maximize expected default losses in a general U.S. subprime meltdown, then Paulson's participation would again be immaterial and the complaint is based on a fundamental misapprehension of the economics of the transaction.

Goldman's Defense: Immateriality

- Goldman held a long position in Abacus and lost \$90 million in the deal.
 - Materiality can be assessed by contrasting the allegedly false information with the disclosure that would have constituted the truth. Is the difference material?
 - The truth would here have disclosed that Goldman was long, Paulson was short, and that Paulson had participated in the portfolio selection process.
 - Because Goldman had far more prestige in the market than Paulson, this truthful information would have generated even more interest in the Abacus transaction among longs than any interest arising from the alleged misrepresentation or omission, which, in any event, never occurred.
- Thus, even if there was a misrepresentation or omission, disclosure of the full truth would have caused even greater interest among the longs, thereby further negating any suggestion of materiality, negligence, or scienter.
- The SEC can't have it both ways. It can't argue that Paulson's short had to be disclosed but that Goldman's long in the same transaction was irrelevant.

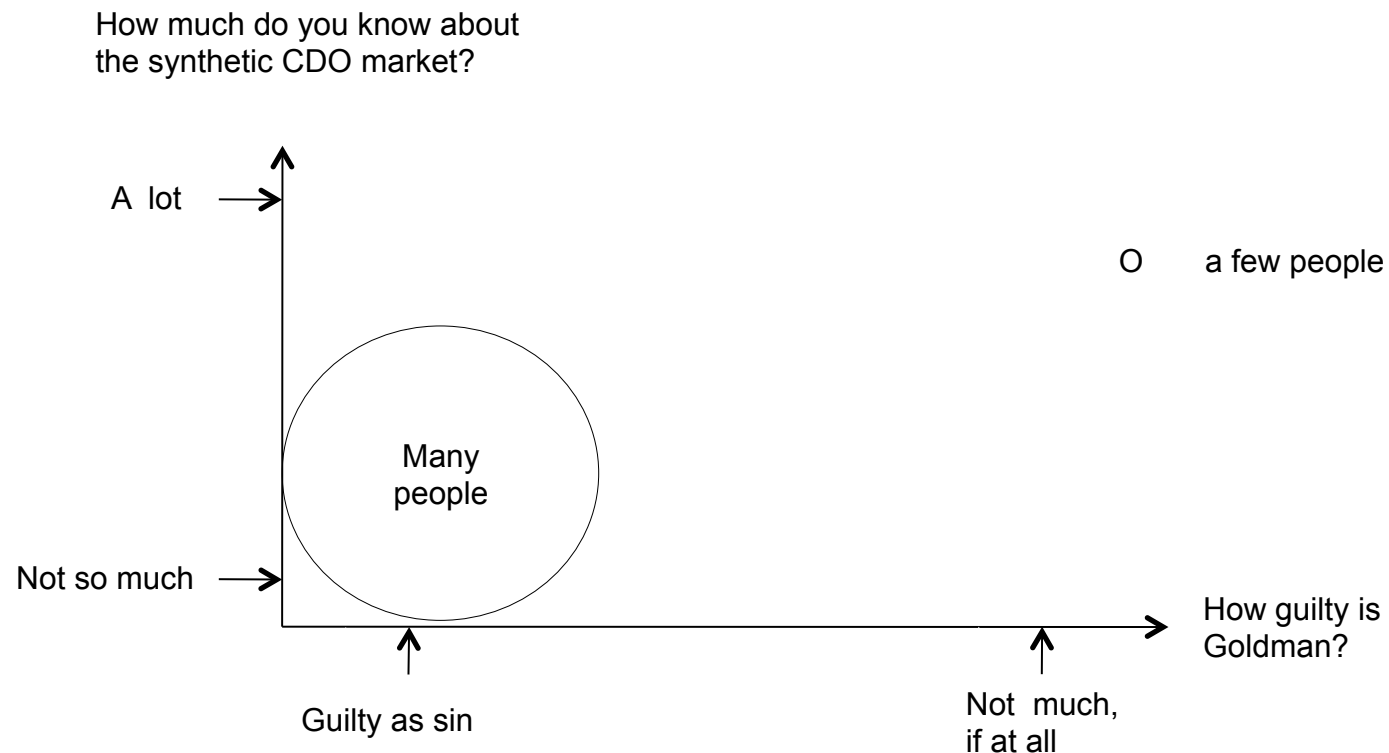
Goldman's Defense: The SEC Twice Contradicts Itself

- First Contradiction: ACA's role.
 - ACA was a highly sophisticated market analyst.
 - If Paulson was successful in loading the portfolio with particularly toxic Baa2 securities, why would ACA purchase \$42 million in notes and write \$909 million notional CDS referencing that portfolio? ACA was viewed as more sophisticated than Paulson.
 - Evidently, ACA thought the portfolio names were strong enough that they were willing to go long the portfolio.
 - If the portfolio is good enough for ACA then it's also good enough for IKB.
- Second contradiction: The Commission suggests that Goldman should have violated client confidences by disclosing Paulson's position.
 - Brokers have a duty "to maintain the confidentiality of client information."¹
 - Paulson was a client.
 - But the Commission suggests Goldman had an obligation to divulge confidential information about Paulson and his position, notwithstanding the information's essential immateriality.
 - How can Goldman be sued for maintaining client information as confidential when it had an obligation to maintain the information as confidential?

¹ In re Thomas v. Heath, III, Sec Rel. No 59223, at 4 (January 9, 2009).

Who Thinks Goldman is Guilty? An Unscientific, Small Sample Survey

Observation: The more you know about the market, the less likely you are to side with the SEC's interpretation of events.



Goldman's Probable Strategy

- The usual strategy in litigating with the SEC is not to comment publicly.
- Goldman has obviously rejected the usual strategy and is embarked on a vigorous public defense.
- Goldman will have to educate, educate, educate. The more policymakers, the press, and the public understand about the operation of the synthetic CDS market, and about marketmaking, the better Goldman's chances.
- If the litigation results in a jury trial, Goldman will likely try to get a smart, sophisticated jury with real world business experience. The SEC will likely go the opposite direction.
- Fight hard. Don't give an inch. Challenge every detail. The complaint is not the strongest that the Commission has ever filed. The more doubt Goldman raises about the complaint, the better it will do in the court of public opinion, the better it will do at trial, and the better the settlement it will negotiate (assuming that the case settles).
- Push for an aggressive discovery schedule and try to move to trial as quickly as possible. Get exculpatory information into the public domain. Again, this strategy simultaneously promotes victory in the courtroom and a favorable settlement.

The Bigger Picture

- Even if Goldman wins in the court of law, it has taken a public relations hit in the court of public opinion.
- The question of a broker's obligations to clients is now clearly front and center, including the questions of whether brokers should have a fiduciary obligation to clients, and the performance of market-making functions.
- The debate now also encompasses the rationale for the existence of certain complex derivatives.
- Given the political reality of the current legislative process, negative publicity regarding Goldman helps support stronger regulation of the financial sector in general, and of the derivatives market in particular.