Stanford experts assess SEC-Goldman suit, stress need to better regulate financial markets

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(PhysOrg.com) -- Two Stanford experts on the finance industry distinguished between ethical and legal issues during a public analysis of the Securities and Exchange Commission's lawsuit against Goldman Sachs' allegedly fraudulent Abacus deal. Both came down in favor of stiffer regulation of derivative markets.

Hours after Goldman Sachs executives endured a grilling by angry U.S. Senators on Capitol Hill April 27, two senior Stanford faculty members explained to a standing-room-only crowd the intricacies of the synthetic CDO market and measured the strengths and weaknesses of the Securities and Exchange Commission's landmark lawsuit against the nation's most powerful investment bank.

Although the SEC's complaint and press reports have painted Goldman's massive bets on the mortgage market as negligent at best and fraudulent at worst, the facts are complex, and it appears that the Commission may well have a difficult time proving its case. "The less people know about the market, the more likely they are to believe Goldman is guilty," said Joseph Grundfest, a professor at Stanford Law School and former SEC commissioner. But more knowledge leads to doubt about the strength of the complaint, he said, adding, "This is not the strongest case the SEC has ever filed."

Darrell Duffie, a professor of finance at the Stanford Graduate School of Business and an expert on complex derivatives, explained the intricacies of a deal known as Abacus 2007 AC-1, a $2 billion securities package at the heart of the federal complaint, and concluded that Goldman's economic incentives for the performance of the deal were the same as those of the Abacus investors. Like those investors, Goldman ended up losing money, a net loss of $75 million after fees.

However, Goldman's clients, who purchased the Abacus securities arranged by Goldman, suffered a loss of about $1 billion, while John Paulson, a hedge fund manager on the other side of the deal, landed a $1.1 billion profit.

Neither Grundfest nor Duffie expressed any approval of the deal or of the impenetrably complex financial mechanisms that led to the collapse of the housing market and subsequent recession. Indeed, both came out on the side of stricter regulation of the financial markets in general and the derivatives market in particular.

"The government," said Duffie, "needs to enact legislation that will make the markets safer and more transparent." Grundfest sounded a similar note but said the public perception that there were no laws on the books that could have prevented the financial collapse was incorrect. AIG (the giant insurance company bailed out by the U.S. Treasury) was in fact regulated by the Office of Thrift Supervision, "but the government did not know how to use the power it had," he said.
Their discussion was sponsored by the Arthur and Toni Rembe Rock Center for Corporate Governance, a collaborative effort of the Stanford Law School and Stanford Graduate School of Business.

Unraveling the Abacus deal

The Abacus deal began in 2007, when John Paulson, the manager of a hedge fund bearing his name, asked Goldman to help him arrange a short position on a portfolio of sub-prime and mid-prime residential mortgage-backed securities, or RMBS for short.

Why would Paulson want to be short? He believed, correctly as it turned out, that the mortgage market was close to collapse and he wanted to profit from the disaster.

Paulson took his position through a series of credit default swaps (CDS) referencing a portfolio of 90 RMBS, each for a principal amount of $22.22 million, for a total of $2 billion, Duffie said. In essence, a credit default swap is a bet that a security will default or lose much of its value. Much like the holder of a life or fire insurance policy, the holder of the CDS pays a premium to the insurer, and only gets a payout if the insured security fails.

There could be as many 1,000 individual loans linked to each one of these 90 securities. Most of the 90 mortgage-backed securiites, whose cash flows depended such a portfolio of mortgage loans, were rated Triple-B, an investment grade rating. Duffie explained how the 90 securities determined the payoffs to each of the Abacus packages, through a series of transactions. Paulson, who is not charged in the complaint, played a role in the selection of the 90 capital RMBS, in a process whose role is central the SEC's case.

The SEC contends that Paulson knowingly selected the worst securities -- that is, those most likely to fail -- because he was building a short position. Goldman doesn't deny knowing that Paulson was short, but contends that the companies on the opposite side of the trade -- called ACA and IKB -- had to be aware that the deal couldn't exist if no one held a short position.

"It would be a different story if Goldman conspired with Paulson to put bad collateral into the structure in order to take advantage of an unsophisticated investor, but I myself have seen no evidence of it yet," Duffie said in an interview after the discussion.

The way the deal was structured, ACA and IKB were responsible for approximately 95 percent of any potential loss, while Goldman was responsible for the remaining 5 percent. Paulson would get no money from the deal until losses reached $420 million. As the losses escalated, his return would escalate. When the entire $2 billion bundle of securities failed, he received $1.1 billion.

Despite the popular impression that Goldman held a short position on Abacus, it did not, Duffie said. Did they hold short positions on other packages that were similar to Abacus? Duffie said that's a possibility, but he does not know if the company actually did. (The New York Times has written that Abacus was one of 25 such vehicles that Goldman created so the bank and some of its clients could bet against the housing market.)

Goldman actually lost approximately $90 million on the Abacus transaction itself, but was paid $15 million by its clients, leaving a net loss of about $75 million.
ACA's losses, which were ultimately much larger than IKB's, were effectively guaranteed by a company called ABN Amro, which was acquired by the Royal Bank of Scotland and suffered a huge loss.

Goldman vs. the SEC

To convince a judge or jury that Goldman is guilty, the SEC has a rather heavy burden, Grundfest said. It has to show that Goldman withheld information that a short seller was a key part of the deal. Goldman denies that, but even if it were true, the SEC would have to prove that the omission was material, that is, legally significant, he said.

(Eric Kolchinsky, a former employee of Moody's who oversaw its ratings of sub-prime collateralized debt obligations, told a Senate subcommittee that neither he nor his staff knew or suspected that Paulson was involved. Asked by U.S. Sen. Carl Levin if that mattered, he replied: "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.")

The SEC will also have to prove that Goldman knew its actions were inappropriate and negligent, and that it intended to deceive its investors. It will have to show that Goldman engaged in "highly unreasonable" conduct that "represents an extreme departure from the standards of ordinary care."

Goldman's defense, said Grundfest, will probably include assertions that it never lied or deceived any of its clients about Paulson's role in selecting the portfolio and that he was going to be short. The company will argue that its practices were consistent with industry standards and not negligent. And it will likely say that the clients were told and should have understood that there had to be a short side of the transaction.

No matter how the suit is resolved, it's already apparent that it has bolstered the case for Democrats who argue that more financial regulation is imperative. "Agree or not, that's simply the political reality," Grundfest said.

It's also apparent that the SEC's complaint is likely to spawn further litigation by private parties, various states, and quite possibly foreign governments. Win or lose, Goldman has suffered a black eye that will take some time to heal. And the SEC is looking at other mortgage-related deals in which Goldman held short positions.

If the case is lost because the evidence was weak, it will be yet another black eye for the SEC, which is still being criticized for missing Bernard Madoff's huge fraud. But if it loses because the law was weak, it will be yet another argument for strong action by Congress, said Grundfest.

There's a larger question, as well: Has Wall Street lost its way, manufacturing complex instruments that serve no useful social function instead of providing capital to real companies? "There is a justified outrage that the financial sector did not do a good job, and that led to a crisis," said Duffie. He argued that the trading of derivatives should be regulated -- but not outlawed. "We do not want to eliminate them, but we do need to see that people involved have enough capital and that they are risking their own and not other people's money."

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