

They bet on a meltdown, and won

A McClatchy investigation found that investment bank giant Goldman Sachs made secret bets on an imminent housing crash — while selling off billions in soon-to-be worthless securities

BY GREG GORDON
McClatchy Newspapers

WASHINGTON — In 2006 and 2007, Goldman Sachs Group peddled more than \$40 billion in securities backed by at least 200,000 risky home mortgages, but never told the buyers it was secretly betting that a sharp drop in U.S. housing prices would send the value of those securities plummeting.

Goldman's sales and its clandestine wagers, completed at the brink of the housing market meltdown, enabled the nation's premier investment bank to pass most of its potential losses to others before a flood of mortgage defaults staggered the U.S. and global economies.

Only later did investors discover that what Goldman had promoted as triple-A rated investments were closer to junk.

Now, pension funds, insurance companies, labor unions and foreign financial institutions that bought those dicey mortgage securities are facing large losses, and a five-month McClatchy investigation has found that Goldman's failure to disclose that it made secret, exotic bets on an imminent housing crash may have violated securities laws.

"The Securities and Exchange Commission should be very interested in any financial company that secretly decides a financial product is a loser and then goes out and actively markets that product or very similar products to unsuspecting customers without disclosing its true opinion," said Laurence Kotlikoff, a Boston University economics professor who's proposed a massive overhaul of the nation's banks. "This is fraud and should be prosecuted."

John Coffee, a Columbia University law professor who served on an advisory committee to the New York Stock Exchange, said that investment banks have wide latitude to manage their assets, and so the legality of Goldman's maneuvers depends on what its executives knew at the time.

"It would look much more damaging," Coffee said, "if it appeared that the firm was dumping these investments because it saw them as toxic waste and virtually worthless."

Lloyd Blankfein, Goldman's chairman and chief executive, declined to be interviewed for this article.

A Goldman spokesman, Michael DuVally, said that the firm decided in December 2006 to reduce its mortgage risks and did so by selling off subprime-related securities and making myriad insurance-like bets, called credit-default swaps, to "hedge" against a housing downturn.

DuVally told McClatchy that Goldman "had no obligation to disclose how it was managing its risk, nor would investors have expected us to do so ... other market participants had access to the same information we did."

For the past year, Goldman has been on the defensive over its Washington connections and the billions in federal bailout funds it received. Scant attention has been paid, however, to how it became the only major Wall Street player to extricate itself from the subprime securities market before the housing bubble burst.

Goldman remains, along with Morgan Stanley, one of two venerable Wall Street investment banks still standing. Their grievously wounded peers Bear Stearns and Merrill Lynch fell into the arms of retail banks, while another, Lehman Brothers, folded.

To piece together Goldman's role in the subprime meltdown, McClatchy reviewed hundreds of documents, SEC filings, copies of secret investment circulars, lawsuits and interviewed numerous people familiar with the firm's activities.

McClatchy's inquiry found that Goldman Sachs:

- Bought and converted into high-yield bonds tens of thousands of mortgages from subprime lenders that became the subjects of FBI investigations into whether they'd misled borrowers or exaggerated applicants' incomes to justify making hefty loans.

- Used offshore tax havens to shuffle its mortgage-backed securities to institutions worldwide, including European and Asian banks, often in secret deals run through the Cayman Islands, a British territory in the Caribbean that companies use to bypass U.S. disclosure requirements.

- Has dispatched lawyers across the country to repossess homes from bankrupt or financially struggling individuals, many of whom lacked sufficient credit or income but got subprime mortgages anyway because Wall Street made it easy for them to qualify.

- Was buoyed last fall by key federal bailout decisions, at least two of which involved then-Treasury Secretary Henry Paulson, a former Goldman chief executive whose staff at Treasury included several other Goldman alumni.

The firm benefited when Paulson elected not to save rival Lehman Brothers from collapse, and when he organized a massive res-



On the web:

<http://tinyurl.com/yhgst5c>

Includes a video: McClatchy's Greg Gordon talks about his reporting on Goldman Sachs' involvement in the U.S. housing crash.

About the series:

To read more about McClatchy's five-month investigation into Goldman Sachs' role in the subprime mortgage meltdown, visit <http://www.mcclatchydc.com/goldman/>

cue of tottering global insurer American International Group while in constant telephone contact with Goldman chief Blankfein. With the Federal Reserve Board's blessing, AIG later used \$12.9 billion in taxpayers' dollars to pay off every penny it owed Goldman.

These decisions preserved billions of dollars in value for Goldman's executives and shareholders. For example, Blankfein held 1.6 million shares in the company in September 2008, and he could have lost more than \$150 million if his firm had gone bankrupt.

With the help of more than \$23 billion in direct and indirect federal aid, Goldman appears to have emerged intact from the economic implosion, limiting its subprime losses to \$1.5 billion. By repaying \$10 billion in direct federal bailout money — a 23 percent taxpayer return that exceeded federal officials' demand — the firm has escaped tough federal limits on 2009 bonuses to executives of firms that received bailout money.

Goldman announced record earnings in July, and the firm is on course to surpass \$50 billion in revenue in 2009 and to pay its employees more than \$20 billion in year-end bonuses.

THE BLUEST OF THE BLUE CHIPS

For decades, Goldman, a bastion of Ivy League graduates that was founded in 1869, has cultivated an elite reputation as home to the best and brightest and a tradition of urging its executives to take turns at public service.

As a result, Goldman has operated a virtual jobs conveyor belt to and from Washington: Paulson, as Treasury secretary, sent tens of billions of taxpayers' dollars to rescue Wall Street in 2008, and former Goldman employees populate some of the most demanding and powerful posts in Washington. Savvy federal regulators have migrated from their Washington jobs to Goldman.

On Oct. 16, a Goldman vice president,

Adam Storch, was named managing executive of the SEC's enforcement division.

Goldman's financial panache made its sales pitches irresistible to policymakers and investors alike, and may help explain why so few of them questioned the risky securities that Goldman sold off in a 14-month period that ended in February 2007.

Since the collapse of the economy, however, some of those investors have changed their opinions of Goldman.

Several pension funds, including Mississippi's Public Employees' Retirement System, have filed suits, seeking class-action status, alleging that Goldman and other Wall Street firms negligently made "false and misleading" representations of the bonds' true risks.

Mississippi Attorney General Jim Hood, whose state has lost \$5 million of the \$6 million it invested in Goldman's subprime mortgage-backed bonds in 2006, said the state's funds are likely to lose "hundreds of millions of dollars" on those and similar bonds.

Hood assailed the investment banks "who packaged this junk and sold it to unwary investors."

California's huge public employees' retirement system, known as CALPERS, purchased \$64.4 million in subprime mortgage-backed bonds from Goldman on March 1, 2007. While that represented a tiny percentage of the fund's holdings, in July CALPERS listed the bonds' value at \$16.6 million, a drop of nearly 75 percent, according to documents obtained through a state public records request.

In May, without admitting wrongdoing, Goldman became the first firm to settle with the Massachusetts attorney general's office as it investigated Wall Street's subprime dealings. The firm agreed to pay \$60 million to the state, most of it to reduce mortgage balances for 714 aggrieved homeowners.

Attorney General Martha Coakley, now a candidate to succeed Edward Kennedy in the U.S. Senate, cited the blight from foreclosed homes in Boston and other Massachusetts cities. She said her office focused on investment banks because they provided a market for loans that mortgage lenders "knew or should have known were destined for failure."

New Orleans' public employees' retirement system, an electrical workers union and the New Jersey carpenters union also are suing Goldman and other Wall Street firms over their losses.

The full extent of the losses from Goldman's mortgage securities isn't known, but data obtained by McClatchy show that insurance companies, whose annuities provide income for many retirees, collectively paid \$2 billion for Goldman's risky high-yield bonds.

Among the bigger buyers: Ambac

Assurance purchased \$923 million of Goldman's bonds; the Teachers Insurance and Annuities Association, \$141.5 million; New York Life, \$96 million; Prudential, \$70 million; and Allstate, \$40.5 million, according to the data from the National Association of Insurance Commissioners.

In 2007, as early signs of trouble rippled through the housing market, Goldman paid a discounted price of \$8.8 million to repurchase subprime mortgage bonds that Prudential had bought for \$12 million.

Nearly all the insurers' purchases were made in 2006 and 2007, after mortgage lenders had lifted most traditional lending criteria in favor of loans that required little or no documentation of borrowers' incomes or assets.

While Goldman was far from the biggest player in the risky mortgage securitization business, neither was it small.

From 2001 to 2007, Goldman hawked at least \$135 billion in bonds keyed to risky home loans, according to analyses by McClatchy and the industry newsletter Inside Mortgage Finance.

In addition to selling about \$39 billion of its own risky mortgage securities in 2006 and 2007, Goldman marketed at least \$17 billion more for others.

It also was the lead firm in marketing about \$83 billion in complex securities, many of them backed by subprime mortgages, via the Caymans and other offshore sites, according to an analysis of unpublished industry data by Gary Kopff, a securitization expert.

In at least one of these offshore deals, Goldman exaggerated the quality of more than \$75 million of risky securities, describing the underlying mortgages as "prime" or "midprime," although in the U.S. they were marketed with lower grades.

Goldman spokesman DuVally said that Moody's, the bond rating firm, gave them higher grades because the borrowers had high credit scores.

Goldman's securities came in two varieties: those tied to subprime mortgages and those backed by a slightly higher grade of loans known as Alt-A's.

Over time, both types of mortgages required homeowners to pay rapidly rising interest rates. Defaults on subprime loans were responsible for last year's housing meltdown. Interest rates on Alt-A loans, which began to rocket upward this year, are causing a new round of defaults.

Goldman has taken multiple steps to put its subprime dealings behind it, including publicly saying that Wall Street firms regret their mistakes. Last winter, the company cancelled a Las Vegas conference, avoiding any images of employees flashing wads of bonus cash at casinos.

More recently, the firm has launched a public relations campaign to answer the crit-

icism of its huge bonuses, Washington connections and federal bailout. In late October, Blankfein argued that Goldman's activities serve "an important social purpose" by channeling pools of money held by pension funds and others to companies and governments around the world.

KNOWING WHEN TO FOLD THEM

For investment banks such as Goldman, the trick was knowing when to exit the high-stakes subprime game before getting burned.

New York hedge fund manager John Paulson was one of the first to anticipate disaster. He told Congress that his researchers discovered by early 2006 that many subprime loans covered the homes' entire value, with no down payments, and so he figured that the bonds "would become worthless."

He soon began placing exotic bets — credit-default swaps — against the housing market. His firm, Paulson & Co., booked a \$3.7 billion profit when home prices tanked and subprime defaults soared in 2007 and 2008. (He isn't related to Henry Paulson.)

At least as early as 2005, Goldman similarly began using swaps to limit its exposure to risky mortgages, the first of multiple strategies it would employ to reduce its subprime risk.

The company has closely guarded the details of most of its swaps trades, except for \$20 billion in widely publicized contracts it purchased from AIG in 2005 and 2006 to cover mortgage defaults or ratings downgrades on subprime-related securities it offered offshore.

In December 2006, after "10 straight days of losses" in Goldman's mortgage business, Chief Financial Officer David Viniar called a meeting of mortgage traders and other key personnel, Goldman spokesman DuVally said.

Shortly after the meeting, he said, it was decided to reduce the firm's mortgage risk by selling off its inventory of bonds and betting against those classes of securities in secretive swaps markets.

DuVally said that at the time, Goldman executives "had no way of knowing how difficult housing or financial market conditions would become."

In early 2007, the firm's mortgage traders also bet heavily against the housing market on a year-old subprime index on a private London swap exchange, said several Wall Street figures familiar with those dealings, who declined to be identified because the transactions were confidential.

The swaps contracts would pay off big, especially those with AIG. When Goldman's securities lost value in 2007 and early 2008, the firm demanded \$10 billion, of which AIG reluctantly posted \$7.5 billion, Viniar disclosed last spring.

As Goldman's and others' collateral demands grew, AIG suffered an enormous cash squeeze in September 2008, leading to the taxpayer bailout to prevent worldwide losses. Goldman's payout from AIG included more than \$8 billion to settle swaps contracts.

DuVally said Goldman has made other bets with hundreds of unidentified counterparties to insure its own subprime risks and to take positions against the housing market for its clients. Until the end of 2006, he said, Goldman was still betting on a strong housing market.

However, Goldman sold off nearly \$28 billion of risky mortgage securities it had issued in the U.S. in 2006, including \$10 billion on Oct. 6, 2006. The firm unloaded another \$11 billion in February 2007, after it had intensified its contrary bets. Goldman also stopped buying risky home mortgages after the December meeting, though DuVally declined to say when.

I'VE GOT A SECRET

Despite updating its numerous disclosures to investors in 2007, Goldman never revealed its secret wagers.

Asked whether Goldman's bond sellers knew about the contrary bets, spokesman DuVally said the company's mortgage business "has extensive barriers designed to keep information within its proper confines."

However, Viniar, the Goldman finance chief, approved the securities sales and the simultaneous bets on a housing downturn. Dan Sparks, a Texan who oversaw the firm's mortgage-related swaps trading, also served as the head of Goldman Sachs Mortgage

from late 2006 to April 2008, when he abruptly resigned for personal reasons.

The Securities Act of 1933 imposes a special disclosure burden on principal underwriters of securities, which was Goldman's role when it sold about \$39 billion of its own risky mortgage-backed securities from March 2006 to February 2007.

The firm maintains that the requirement doesn't apply in this case.

DuVally said the firm sold virtually all its subprime-related securities to Qualified Institutional Buyers, a class of sophisticated investors that are afforded fewer protections than small investors are under federal securities laws. He said Goldman made all the required disclosures about risks.

Whether companies are obliged to inform investors about such contrary trades, or "hedges," is "a very hot issue" in cases winding through the courts, said Frank Partnoy, a University of San Diego law professor who specializes in securities. One issue is how specific companies must be in disclosing potential risks to investors, he said.

Coffee, the Columbia University law professor, said that any potential violations of securities laws would depend on what Goldman executives knew about the risks ahead.

"The critical moment when Goldman would have the highest liability and disclosure obligations is when they are serving as an underwriter on a registered public offering," he said. "If they are at the same time desperately seeking to get out of the field, that kind of bailout does look far more dubious than just trading activities."

Another question is whether, by keeping

the trades secret, the company withheld material information that would enable investors to assess Goldman's motives for selling the bonds, said James Cox, a Duke University law professor who also has served on the NYSE advisory panel.

If Goldman had disclosed the contrary bets, he said, "One would have to believe that a rational investor would not only consider Goldman's conduct material, but likely compelling a decision to take a pass on the recommendation to purchase."

Cox said that existing laws, however, don't require sufficient disclosures about trading, and that the government would do well to plug that hole.

In marketing disclosures filed with the SEC regarding each pool of subprime bonds from 2001 to 2007, Goldman listed an array of risk factors that grew over time. Among them was the possibility of a pullback in overheated real estate markets, especially in California and Florida, where the most subprime loans had been made.

Suits filed by the pension funds, however, allege that Goldman made materially false or misleading statements in its public offerings, failing to disclose that many loans were based on inflated appraisals and were bought from firms with poor lending practices.

DuVally said that investors were fully informed of all known risks.

"What's going to happen in the next few years," said San Diego's Partnoy, "is there's going to be a lot of lawsuits and judges will have to decide, should Goldman have disclosed more or not?"

(Tish Wells contributed to this article.)

Insiders claim Moody's sold out investors

A McClatchy investigation found that top debt-rating firm Moody's undermined the integrity of its ratings in pursuit of profits, which may have helped lead to the financial crisis

By KEVIN G. HALL
McClatchy Newspapers

WASHINGTON — As the housing market collapsed in late 2007, Moody's Investors Service, whose investment ratings were widely trusted, responded by purging analysts and executives who warned of trouble and promoting those who helped Wall Street plunge the country into its worst financial crisis since the Great Depression.

A McClatchy investigation has found that Moody's punished executives who questioned why the company was risking its reputation by putting its profits ahead of providing trustworthy ratings for investment offerings.

Instead, Moody's promoted executives who headed its "structured finance" division, which assisted Wall Street in packaging loans into securities for sale to investors. It also stacked its compliance department with the people who awarded the highest ratings to pools of mortgages that soon were downgraded to junk. Such products have another name now: "toxic assets."

As Congress tackles the broadest proposed overhaul of financial regulation since the 1930s, however, lawmakers still aren't fully aware of what went wrong at the bond rating agencies, and so they may fail to address misaligned incentives such as granting stock options to mid-level employees, which can be an incentive to issue positive ratings rather than honest ones.

The Securities and Exchange Commission issued a blistering report on how profit motives had undermined the integrity of ratings at Moody's and its main competitors, Fitch Ratings and Standard & Poor's, in July 2008, but the full extent of Moody's internal strife never has been publicly revealed.

Moody's, which rates McClatchy's debt and assigns it quite low value, disputes every allegation against it. "Moody's has rigorous standards in place to protect the integrity of ratings from commercial considerations," said Michael Adler, Moody's vice president for corporate communications, in an e-mail response to McClatchy.

Insiders, however, say that wasn't true before the financial meltdown.

"The story at Moody's doesn't start in 2007; it starts in 2000," said Mark Froeba, a Harvard-educated lawyer and senior vice president who joined Moody's structured finance group in 1997.

"This was a systematic and aggressive strategy to replace a culture that was very conservative, an accuracy-and-quality oriented (culture), a getting-the-rating-right kind of culture, with a culture that was supposed

to be 'business-friendly,' but was consistently less likely to assign a rating that was tougher than our competitors," Froeba said.

After Froeba and others raised concerns that the methodology Moody's was using to rate investment offerings allowed the firm's profit interests to trump honest ratings, he and nine other outspoken critics in his group were "downsized" in December 2007.

"As a matter of policy, Moody's does not comment on personnel matters, but no employee has ever been let go for trying to strengthen our compliance function," Adler said.

Moody's was spun off from Dun & Bradstreet in 2000, and the first company shares began trading on Oct. 31 that year at \$12.57. Executives set out to erase a conservative corporate culture.

To promote competition, in the 1970s ratings agencies were allowed to switch from having investors pay for ratings to having the issuers of debt pay for them. That led the ratings agencies to compete for business by currying favor with investment banks that would pay handsomely for the ratings they wanted.

Wall Street paid as much as \$1 million for some ratings, and ratings agency profits soared. This new revenue stream swamped earnings from ordinary ratings.

"In 2001, Moody's had revenues of \$800.7 million; in 2005, they were up to \$1.73 billion; and in 2006, \$2.037 billion. The exploding profits were fees from packaging . . . and for granting the top-class AAA ratings, which were supposed to mean they were as safe as U.S. government securities," said Lawrence McDonald in his recent book, "A Colossal Failure of Common Sense."

He's a former vice president at now defunct Lehman Brothers, one of the high-flying investment banks that helped create the global crisis.

From late 2006 through early last year, however, the housing market unraveled, poisoning first mortgage finance, then global finance. More than 60 percent of the bonds backed by mortgages have had their ratings downgraded.

"How on earth could a bond issue be AAA one day and junk the next unless something spectacularly stupid has taken place? But maybe it was something spectacularly dishonest, like taking that colossal amount of fees in return for doing what Lehman and the rest wanted," McDonald wrote.

Ratings agencies thrived on the profits that came from giving the investment banks what they wanted, and investors worldwide gorged themselves on bonds backed by U.S.



On the web:

<http://tinyurl.com/ybsff3y>

Includes a video: McClatchy's Kevin G. Hall talks about his reporting on Moody's Investors Service.

More information:

To read the sidebar accompanying this story, featuring a Q-and-A with a representative of Moody's Investors Service, visit <http://tinyurl.com/yzmfofa>

car loans, credit card debt, student loans and, especially, mortgages.

Before granting AAA ratings to bonds that pension funds, university endowments and other institutional investors trusted, the ratings agencies didn't bother to scrutinize the loans that were being pooled into the bonds. Instead, they relied on malleable mathematical models that proved worthless.

"Everyone else goes out and does factual verification or due diligence. The credit rating agencies state that they are just assuming the facts that they are given," said John Coffee, a finance expert at Columbia University. "This system will not get fixed until someone credible does the necessary due diligence."

Nobody cared about due diligence so long as the money kept pouring in during the housing boom. Moody's stock peaked in February 2007 at more than \$72 a share.

Billionaire investor Warren Buffett's firm Berkshire Hathaway owned 15 percent of Moody's stock by the end of 2001, company reports show. That stake, largely still intact, meant that the Oracle from Omaha reaped huge financial rewards while Moody's overlooked the glaring problems in pools of subprime mortgages.

A Berkshire spokeswoman had no comment.

One Moody's executive who soared through the ranks during the boom years was Brian Clarkson, the guru of structured finance. He was promoted to company president just as the bottom fell out of the housing market.

Several former Moody's executives said he made subordinates fear they'd be fired if they didn't issue ratings that matched competitors' and helped preserve Moody's market share.

Froeba said his Moody's team manager would tell his team that he, the manager, would be fired if Moody's lost a single deal. "If your manager is saying that at meetings, what is he trying to tell you?" Froeba asked.

In the 1990s, Sylvain Raynes helped pioneer the rating of so-called exotic assets. He worked for Clarkson.

"In my days, I was pressured to do nothing, to not do my job," said Raynes, who left

Moody's in 1997. "I saw in two instances — two deals and a rental car deal — manipulation of the rating process to the detriment of investors."

When Moody's went public in 2000, mid-level executives were given stock options. That gave them an incentive to consider not just the accuracy of their ratings, but the effect they'd have on Moody's — and their own — bottom lines.

"It didn't force you into a corrupt decision, but none of us thought we were going to make money working there, and suddenly you look at a statement online and it's (worth) hundreds and hundreds of thousands (of dollars). And it's beyond your wildest dreams working there that you could make that kind of money," said one former mid-level manager, who requested anonymity to protect his current Wall Street job.

Moody's spokesman Adler insisted that compensation of Moody's analysts and senior managers "is not linked to the financial performance of their business unit."

Clarkson couldn't be reached to comment.

Clarkson's own net worth was tied up in Moody's market share. By the time he was pushed out in May 2008, his compensation approached \$3 million a year.

Clarkson rose to the top in August 2007, just as the subprime crisis was claiming its first victims. Soon afterward, a number of analysts and compliance officials who'd raised concerns about the soundness of the ratings process were purged and replaced with people from structured finance.

"The CEO is from a structured finance background, most of the people in the leadership were from a structured finance background, and it was putting their people in the right places," said Eric Kolchinsky, a managing director in Moody's structured finance division from January 2007 to November 2007, when he was purged, he said, for questioning some of the ratings. "If they were serious about compliance, they wouldn't have done that, because it isn't about having friends in the right places, but doing the right job."

Another mid-level Moody's executive, speaking on the condition of anonymity for fear of retribution, recalls being horrified by the purge.

"It is just something unthinkable, putting business people in the compliance department. It's not acceptable. I was very upset, frustrated," the executive said. "I think they corrupted the compliance department."

One of the new top executives was Michael Kanef, who was experienced in assembling pools of residential mortgage-backed securities, but not in compliance, the division that was supposed to protect

investors.

"What signal does it send when you put someone who ran the group that assigned some of the worst ratings in Moody's history in charge of preventing it from happening again," Froeba said of Kanef. Clarkson and Kanef, who remains at Moody's, were named in a class-action lawsuit alleging that Moody's misled investors about its independence from companies that paid it for ratings.

Kanef went after Scott McCleskey, the vice president of compliance at Moody's from the spring of 2006 until September 2008, and the man that Moody's said was the one to see for all compliance matters.

"It's speculation, but I think Scott was trying to get people to follow some rules and people weren't ready to accept that there should be rules," Kolchinsky said.

McCleskey testified before the House of Representatives Oversight and Government Reform Committee on Sept. 30 and described how he was pushed out on the heels of the people he'd hired.

"One hour after my departure, it was announced that I would be replaced by an individual from the structured finance department who had no compliance experience and who, to my recollection, had been responsible previously for rating mortgage-backed securities," McCleskey testified.

His replacement, David Teicher, had no compliance background. SEC documents describe him as a former team director for mortgage-backed securities from 2006 to 2008.

McCleskey had raised concerns about the integrity of the ratings process, and Moody's had excluded him from meetings in January 2008 with the Securities and Exchange Commission about the eroding quality of pools of subprime loans that Moody's had blessed with top ratings.

SEC officials, however, didn't bother to seek out McCleskey, even though he was the "designated compliance officer" in company filings with the agency. The SEC maintains that its officials met with Kanef because he was McCleskey's superior.

SEC spokesman Erik Hotmire said that officials met with Kanef because "we ask to interview whomever we determine is appropriate."

Another former Moody's executive, requesting anonymity for fear of legal action by the company, said the agency might've understood what was going wrong better if it had talked to the hands-on compliance officials.

"If they had known he'd (Kanef) come from structured finance, the conflict of having him in that position should have been evident from the start," the former executive

said.

Others who worked at Moody's at the time described a culture of willful ignorance in which executives knew how far lending standards had fallen and that they were giving top ratings to risky products.

"I could see it coming at the tail end of 2006, but it was too late. You knew it was just insane," said one former Moody's manager. "They certainly weren't going to do anything to mess with the revenue machine."

Moody's wasn't alone in ignoring the mounting problems. It wasn't even first among competitors. The financial industry newsletter Asset-Backed Alert found that Standard & Poor's participated in 1,962 deals in 2006 involving pools of loans, while Moody's did 1,697. In 2005, Standard & Poor's did 1,754 deals to Moody's 1,120. Fitch was well behind both.

"S&P is deeply disappointed in the performance of its ratings on certain securities tied to the U.S. residential real estate market. As far back as April of 2005, S&P warned investors about increased risks in the residential mortgage market," said Edward Sweeney, a company spokesman. S&P revised criteria and demanded greater buffers against default risks before rating pools of mortgages, he said.

Still, S&P continued to give top ratings to products that analysts from all three ratings agencies knew were of increasingly poor quality. To guard against defaults, they threw more bad loans into the loan pools, telling investors they were reducing risk.

The ratings agencies were under no legal obligation since technically their job is only to give an opinion, protected as free speech, in the form of ratings.

"As an analyst, I wouldn't have known there was a compliance function. There was an attitude of carelessness, or careless ignorance of the law. I think it is a result of the mentality that what we do is just an opinion, and so the law doesn't apply to us," Kolchinsky said.

Experts such as Columbia University's Coffee think that Congress must impose some legal liability on credit rating agencies. Otherwise, they'll remain "just one more conflicted gatekeeper," and the process of pooling loans — essential to the flow of credit — will remain paralyzed and economic recovery restrained.

"If (credit) remains paralyzed, small banks cannot finance the housing demand. They have to take them (investment banks) these mortgages and move them to a global audience," said Coffee. "That can't happen unless the world trusts the gatekeeper."

SEC has let some Wall Street firms off the hook

Financial giants have been given special exemptions from major penalties

By CHRIS ADAMS
McClatchy Newspapers

WASHINGTON — Forget too big to fail. In the eyes of federal regulators, many Wall Street firms are too big to punish.

During the past three years, some of the nation's largest financial firms have been accused by the government of cheating or misleading clients and ripping off tens of thousands of consumers of their investments.

Despite these findings, these financial giants got, sometimes repeatedly, special exemptions from the Securities and Exchange Commission that have saved them from a regulatory death penalty that could have decimated their lucrative mutual fund businesses.

Among the more than a dozen firms that have gotten these SEC get-out-of-jail cards since January 2007 are some of Wall Street's biggest, including Bank of America, Citigroup and American International Group.

SEC rules permit corporate lawbreakers to apply for what are known as Section 9(c) waivers from one of the agency's harshest penalties — effectively shuttering the violator's mutual fund operations — but regulators never rejected any of these firms' applications. While the firms were punished in other ways, they were spared from what some claimed would be "severe and irreparable hardships."

In fact, the last time the SEC's staff could recall a waiver being turned down was 1978. The SEC declined to comment in detail on its decisions, however.

Despite the massive securities frauds of the past decade, the SEC is coming off a period of stagnant enforcement. The Government Accountability Office, Congress' investigative arm, reported this year that SEC enforcement workers have felt overwhelmed by their case-loads and undermined by SEC leaders hesitant to levy heavy punishment.

The waivers typically are part of the settlements the commission negotiates with companies caught violating federal law. Securities experts think companies wouldn't apply for waivers if they didn't think their applications would be granted. At the same time, the fact that the SEC could someday deny one is a major weapon in its arsenal, experts said.

The infractions that led to the waiver applications raided Americans' pocketbooks and savings accounts. Some cases involved money that thousands of citizens had invested based on the advice of their trusted financial advisers to pay tuition bills, make down payments on houses or cope with routine monthly expenses.

Small business owners had money they were counting on to pay their employees frozen by their bankers, and even bigger companies such as KV Pharmaceutical weren't immune. The St. Louis drug maker was forced to eliminate 700 jobs this year, in part because some of its investments went sour.

McClatchy's review of recent waiver applications also found that the SEC has

granted exemptions to the same firms more than once, once after a firm committed the same violation of law, and the agency even approved one for a company that misled the SEC in its application.

Indeed, granting these waivers has become so routine that different firms use identical language, culled from a 1940 congressional hearing, to argue for unrelated exemptions.

Underpinning its decision not to levy the penalties provided by the Investment Company Act of 1940, the SEC essentially has accepted the Wall Street firms' argument that they're too big and too complex to be subject to a law that was written almost 70 years ago.

Earlier this year, for example, the SEC said a division of E-Trade Financial had been slicing tiny amounts of money off "tens of thousands" of stock trades, using tactics such as "trading ahead" of customers. That means that even when a customer had placed an order to buy or sell stocks, E-Trade executed its own trade for the same stock first, denying the customer the best price.

The SEC calculated that E-Trade had cost its customers \$28.3 million. While not admitting guilt, E-Trade settled the case in U.S. District Court in New York and agreed to pay \$34 million in penalties.

In March, E-Trade applied for a Section 9 waiver. Without it, the company said, its in-house mutual fund operation could have been decimated, potentially causing customers "severe and irreparable hardships." It also said that it needed exemption from punishment that "could disrupt investment strategies," "frustrate efforts to manage effectively the funds' assets," and increase the costs to people who owned them, E-Trade said. More than 1,500 employees could be affected.

Eight days later, the SEC indicated that it would grant the request.

Two weeks after that, E-Trade closed the very mutual funds at issue — harming the very customers it told the SEC it was trying to help.

In fact, at the same time E-Trade was asking the SEC to help it save those funds, the company had already filed notice elsewhere at the SEC that it was planning to close them, SEC records show. At the time E-Trade asked for its waiver, most of the funds couldn't even be purchased any more.

The waiver still helps E-Trade because it could allow the company to restart its mutual funds. E-Trade had no comment on its actions.

Sometimes, "permanent" in SEC enforcement parlance has proved to be a temporary thing.

In 2003, Citigroup settled a case after the SEC accused it of manipulating stock market research. The settlement "permanently restrained and enjoined" Citigroup from violating a specific section of federal securities law.

Then in 2006, the SEC cited Citigroup and other firms for improperly marketing "auction rate securities," bonds issued by municipalities, student loan entities and corpora-



More information:

There are two sidebars that accompanied this story:

- "Is a 1940s security law too old to be enforced?" (<http://tinyurl.com/y1rr8aj>)
- "How Bank of America dodged a penalty" (<http://tinyurl.com/yk3e4t2>)

tions. The agency censured Citigroup and fined it \$1.5 million, and Citigroup promised to clean up its sales practices. The SEC indicated that was good enough: In its attempt to deter more lawbreaking, the SEC declared, "this settlement is appropriate."

Two years later, however, Citigroup was back under SEC scrutiny. This time, the SEC said the firm had improperly marketed auction rate securities, violating the same section of law at issue in 2003.

Citigroup again settled with the SEC, and while not admitting the allegations, it again agreed to not violate that key federal securities law.

It was one of those auction rate investments that went sour on KV Pharmaceutical.

Citigroup first approached the firm in 2005 to invest in the securities, pitching them as safe and dependable — perfect for KV's needs. When the market started souring in 2007, however, Citigroup never passed those concerns on to KV, according to a lawsuit the drugmaker eventually filed in federal court.

KV bought \$10.7 million in the securities, then another \$16.9 million. And it kept right on buying them, long after Citigroup traders were receiving e-mails like this one intended to boost sales: "Hit all bids . . . Times like these, we need to do whatever is necessary. Just make sure all hands are on deck and paper is sold," according to court records.

KV, in its lawsuit, said Citigroup "put its economic interests before KV's" in an effort to save Citigroup's own faltering finances. All along, KV said, it was assured there was nothing to worry about.

The auction rate securities market failed in February 2008, and KV was left holding more than \$70 million it couldn't spend.

While the settlements the SEC negotiated with Citigroup and other banks could make some customers whole, it didn't help KV in time. In February, facing a cash crunch, it said it was cutting 700 jobs, due in part to its auction rate problems.

Its lawsuit is pending; neither KV nor Citigroup would comment.

Meanwhile, Citigroup filed its application for a waiver, and the SEC granted it.

In theory, securities law allows the SEC to levy heavier fines or extract greater punishment from companies that violate their previous "permanent" injunctions.

"The SEC has a miserable record of policing and keeping track of recidivism even of prior violations," said James Cox, a Duke University law professor and an expert on financial regulation. "I think it's not uncommon and I think it's a problem."

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