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# S.E.C. Accuses Goldman Of Fraud in Housing Deal

## Suit Says Bank Sold Mortgage Investment Meant to Fail — Firm Issues Denial

By LOUISE STORY and GRETCHEN MORGENSON

Goldman Sachs, the Wall Street powerhouse, was accused of securities fraud in a civil lawsuit filed Friday by the Securities and Exchange Commission, which claims the bank created and sold a mortgage investment that was secretly intended to fail.

The move was the first time that regulators had taken action against a Wall Street deal that helped investors capitalize on the collapse of the housing market.

The suit also named Fabrice Tourre, a vice president at Goldman who helped create and sell the investment.

In a statement, Goldman called the commission's accusations "completely unfounded in law and fact" and said it would "vigorously contest them and defend the firm and its reputation."

The focus of the S.E.C. case, an investment vehicle called Abacus 2007-AC1, was one of 25 such vehicles that Goldman created so the bank and some of its clients could bet against the housing market. Those deals, which were the subject of an article in The New York Times in December, initially protected Goldman from losses when the mortgage market disintegrated and later yielded profits for the bank.

As the Abacus portfolios in the S.E.C. case plunged in value, a prominent hedge fund manager made money from his bets against certain mortgage bonds, while investors lost more than $1 billion.

According to the complaint, Goldman created Abacus 2007-AC1 in February 2007 at the request of John A. Paulson, a prominent hedge fund manager who earned an estimated $3.7 billion in 2007 by correctly wagering that the housing bubble would burst. Mr. Paulson is not named in the suit.

Goldman told investors that the bonds would be chosen by an

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independent manager. In the case of Abacus 2007-AC1, however, Goldman let Mr. Paulson select mortgage bonds that he believed were most likely to lose value, according to the complaint.

Goldman then sold the package to investors like foreign banks, pension funds and insurance companies, which would profit only if the bonds gained value. The European banks IKB and ABN Amro and other investors lost more than $1 billion in the deal, the commission said.

"Goldman wrongly permitted a client that was betting against the mortgage market to heavily influence which mortgage securities to include in an investment portfolio," Robert Khuzami, the director of the commission's enforcement division, said in a written statement.

The lawsuit could be a sign of a revitalized Securities and Exchange Commission, which has been criticized for early missteps in assessing the causes of the financial crisis. The agency appears to be tracing the mortgage pipeline all the way from the companies like Countrywide Financial that originated home loans to the raucous trading floors that dominate Wall Street's profit machine.

At a conference in New Orleans on Friday, Mr. Khuzami indicated that he was scrutinizing other deals involving mortgage securities. "We're looking at a wide range of products," he said at a news conference. "If we see securities with similar profiles, we'll look at them closely."

Shares of Goldman Sachs plunged more than 10 percent in just the first half-hour of trading after the suit was announced Friday morning. They closed down 13 percent, at $160.70, wiping away more than $10 billion of the company's market value.

Investors sold other bank stocks, as well, as rumors swirled about which other firms might become embroiled in the commission's investigation. Next to Goldman Sachs, Deutsche Bank's American shares had the steepest decline, falling 7 percent.

Goldman issued a second statement after the market closed saying that the firm had lost money on the deal in the S.E.C. case and that it provided investors with extensive disclosure on the deal. The firm said the losses in the deal came from the overall collapse of the mortgage market, not from the way the deal was structured.

The accusations amount to a black eye for the once-untouchable Goldman Sachs, a money machine that is the epicenter of Wall Street power. For decades, its platinum reputation has attracted top investors and stock underwriting deals.

Several of its former chief executives have gone on to high public office, among them Henry M. Paulson Jr., the former Treasury secretary, and Jon Corzine, the former New Jersey governor. (Henry Paulson and John Paulson are not related.)

In recent months, Goldman has been defiant in the face of criticism, repeatedly defending its actions in the mortgage market, including its own bets against it. In a letter published last week in Goldman's annual report, the bank rebutted criticism that it had created, and sold to its clients, mortgage-linked securities that it had little confidence in.

"We certainly did not know the future of the residential housing market in the first half of 2007 any more than we can predict the future of markets today," Goldman wrote. "We also did not know whether the value of the instruments we sold would increase or decrease."

The letter continued: "Although Goldman Sachs held various positions in residential mortgage-related products in 2007, our short positions were not a 'bet against our clients.'" Instead, the trades were used to hedge other trading positions, the bank said.

Goldman was one of many Wall Street firms that created complex mortgage securities — known as synthetic collateralized debt obligations — as the housing wave was cresting. At the time, traders like Mr. Paulson, as well as those within Goldman, were looking for ways to bet against the overheated market.

For months, S.E.C. officials have been examining mortgage bundles like Abacus that were created across Wall Street. The commission has been interviewing people who structured Goldman mortgage deals about Abacus and similar instruments. The commission advised Goldman that it was likely to face a civil suit in the matter, sending the bank what is known as a Wells notice several months ago.

The S.E.C. action is a civil complaint, but it could be referred to criminal prosecutors who would have to prove that individuals intended to defraud investors.

The S.E.C. focused on only one Abacus deal in its complaint, but Mr. Khuzami said in a conference call on Friday that the commission continued to look at the rest. All told, $10.9 billion of Abacus investments were sold.

Mr. Tourre, the Goldman vice president named in the lawsuit, was one of the firm's top workers running the Abacus deals, selling the investment to investors across Europe. Mr. Tourre was raised in France and moved to the United States in 2000 to earn his master's degree in operations at Stanford. The next year, he began working at Goldman, according to his profile on the LinkedIn social network.

He rose to prominence working on the Abacus deals under a trader named Jonathan M. Egol. Mr. Egol, who is now a managing director at Goldman, is not named in the S.E.C. suit.

Goldman structured the Abacus portfolios with a sharp eye on the credit ratings assigned to the mortgage bonds contained in them, the S.E.C. said. In the Abacus deal cited in the S.E.C. complaint, Mr. Paulson pinpointed those mortgage bonds that he believed carried higher ratings than the underlying loans deserved.

Goldman placed insurance on those bonds — called credit-default swaps — inside Abacus, allowing Mr. Paulson to bet against the bonds while clients on the other side of the trade wagered that they would make money.

But when Goldman sold shares in Abacus to investors, the bank and Mr. Tourre disclosed only the ratings of those bonds and did not disclose that Mr. Paulson was on the other side, betting those ratings were wrong.

Mr. Tourre at one point complained to an investor who was buying into Abacus that he was having trouble persuading Moody's to give the deal the rating he desired, according to the investor's notes, which were provided to The Times by a colleague who asked for anonymity.

In seven of Goldman's Abacus

*Michael J. de la Merced contributed reporting.*

**ONLINE: MORE ON THE CASE**

*A 2007 marketing document outlines Goldman's guidance to investors about the securities at the heart of the S.E.C. case.*

**nytimes.com/businessday**

DIANE BANDEREFF/ASSOCIATED PRESS

Employees in the lobby of the Goldman Sachs headquarters in Lower Manhattan on Friday. The S.E.C.'s suit is a black eye for the firm, a money machine at the epicenter of Wall Street power.

deals, the bank went to the American International Group for insurance on the bonds. Those deals have led to billions of dollars in losses at A.I.G., which received a $180 billion taxpayer rescue. The Abacus deal in the S.E.C. complaint was not one of them.

That deal was managed by ACA Management, a part of ACA Capital Holdings, which changed its name in 2008 to Manifold Capital.

Goldman told investors the mortgage bond portfolio would be "selected by ACA Management," according to the deal's marketing document, which was given to The Times by an Abacus investor. That document says Goldman may have long or short positions in the bonds. It does not mention Mr. Paulson.

ACA was not named in the suit. That firm was led to believe that Mr. Paulson was positive on mortgages, not negative, and so it did not see a problem with his involvement, the S.E.C. said. Mr. Tourre was aware of ACA's misconception, the commission said.

In February 2007, Mr. Tourre met with both ACA and Mr. Paulson, and he sent an e-mail message to a Goldman colleague acknowledging the awkwardness of the situation. "This is surreal," Mr. Tourre wrote.

Nine days later, a Goldman colleague wrote Mr. Tourre and said, "the C.D.O. biz is dead. We don't have a lot of time left."

The Abacus deals deteriorated rapidly when the housing market hit trouble. For instance, in the Abacus deal in the S.E.C. complaint, 83 percent of the mortgage bonds underlying it were downgraded by rating agencies just six months later, and 99 percent had been downgraded by early 2008, according to the S.E.C.

It takes time for such mortgage investments to pay out for investors who make bets against them. Each deal is structured differently, but generally, the bonds underlying the investment must deteriorate to a certain point before those who bet against the bonds get paid. By the end of 2007, Mr. Paulson's credit hedge fund was up 590 percent.

## Betting Against Their Own Deal

Goldman Sachs created 25 deals under the name Abacus to help it and some of its clients place bets against the housing market. One of them, created by Goldman and the Paulson hedge fund in early 2007, is at the center of a fraud complaint filed by the Securities and Exchange Commission, illustrated here.

### Investors

Purchase an investment in Abacus and, in a sense, become insurers of mortgage bonds. They receive insurance payments from the Paulson fund as long as the bonds don't fail.

### Goldman Sachs

Structures and markets the deal for an initial fee of about $15 million from the Paulson fund. The S.E.C. named one Goldman employee, **Fabrice Tourre,** who worked on the deal.

### The investment deal

The complex deal is made up of a kind of insurance — credit default swaps — that pays out if mortgage bonds start to fail.

By January 2008, 99 percent of the portfolio of mortgage bonds had been downgraded. The investors lost $1 billion, most of it going to the Paulson fund.

**THE ALLEGED FRAUD**

The S.E.C. says Goldman told investors that **ACA Management** chose the mortgage bonds in the Abacus investment. In fact they had been chosen largely by the Paulson fund, which was betting against the same bonds.

### ACA Management

Hired to manage the deal and was led to believe that the Paulson fund was not betting against the bonds, a misconception Mr. Tourre was aware of, according to the S.E.C.

### Paulson hedge fund

According to the S.E.C., the hedge fund manager **John A. Paulson** picked out the mortgage bonds he thought would perform poorly and purchased insurance on them from an Abacus vehicle. If the bonds perform poorly, he got a payout.

*Source: S.E.C. complaint*

THE NEW YORK TIMES

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# A Billionaire Wall St. Celebrity, Now Cast in a Harsh New Light

By GRETCHEN MORGENSON and LOUISE STORY

Three and half years ago, a New York hedge fund manager with a bearish view on the housing market was pounding the pavement on Wall Street.

Eager to increase his bets against subprime mortgages, the investor, John A. Paulson, canvassed firm after firm, looking for new ways to profit from home loans that he was sure would go sour.

Only a few investment banks agreed to help him. One was Deutsche Bank. The other was the mighty Goldman Sachs.

Mr. Paulson struck gold. His prescience made him billions and transformed him from a relative nobody into something of a celebrity on Wall Street and in Washington.

But now his brassy bets have thrust Mr. Paulson into an uncomfortable spotlight. On Friday, the Securities and Exchange Commission filed a civil fraud lawsuit against Goldman for neglecting to tell its customers that mortgage investments they were buying consisted of pools of dubious loans that Mr. Paulson had selected because they were highly likely to fail.

By betting against the pool of questionable mortgage bonds, Mr. Paulson made $1 billion when they collapsed just a few months later, the S.E.C. said. Investors, who bought what regulators are essentially calling a pig in a poke, lost the same amount.

Mr. Paulson, 54, was not named

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as a defendant in the S.E.C. suit, but his role in devising the instrument that caused $1 billion in losses for Goldman's customers is detailed in the complaint. Robert Khuzami, the director of enforcement at the S.E.C., explained that, unlike Goldman, the manager of the hedge fund, Paulson & Company, had not made misrepresentations to investors buying the security, known as a collateralized debt obligation.

"While it's unfortunate that people lost money investing in mortgage-backed securities, Paulson has never been involved in the origination, distribution or structuring of such securities," said Stefan Prelog, a spokesman for Mr. Paulson, in a statement. "We have always been forthright in expressing our opinion as to the quality of the underlying mortgages. Paulson has never misrepresented our positions to any counterparties.

"There's no question we made money in these transactions. However, all our dealings were through arm's-length transactions with experienced counterparties who had opposing views based on all available information at the time. We were straightforward in our dislike of these securities, but the vast majority of people in the market thought we were dead wrong and openly and aggressively purchased the securities we were selling."

Still, the details unearthed by the S.E.C. in its investigation show a deep involvement by Mr. Paulson in the creation of the investment, known as Abacus 2007-AC1. For example, he approached Goldman about constructing and marketing the debt security.

***John Paulson selected pools of dubious loans to bet against them.***

After analyzing risky mortgages made on homes in Arizona, California, Florida and Nevada, where the housing markets had overheated, Mr. Paulson went to Goldman to talk about how he could bet against those loans. He focused his analysis on adjustable-rate loans taken out by borrowers with relatively low credit scores and turned up more than 100 loan pools that he considered vulnerable, the S.E.C. said.

Mr. Paulson then asked Goldman to put together a portfolio of these pools, or others like them that he could wager against. He paid $15 million to Goldman for creating and marketing the Abacus deal, the complaint says.

One of a small cohort of money managers who saw the mortgage market in late 2006 as a bubble waiting to burst, Mr. Paulson capitalized on the opacity of mortgage-related securities that Wall Street cobbled together and sold to its clients. These instruments contained thousands of mortgage loans that few investors bothered to analyze.

Instead, the buyers relied on the opinions of credit ratings agencies like Moody's, Standard & Poor's and Fitch Ratings. These turned out to be overly rosy, and investors suffered hundreds of billions in losses when the loans underlying these securities went bad.

Mr. Paulson personally made an estimated $3.7 billion in 2007 as a result of his hedge fund's performance, and another $2 billion in 2008.

He was also treated like a celebrity by members of a Congressional committee that invited him to testify in November 2008 about

RICK MAIMAN/BLOOMBERG NEWS

The investor John Paulson became a Wall Street celebrity.

the credit crisis. At the time, none of the lawmakers asked how he had managed to set up his lucrative trades; they seemed more interested in getting his advice on how to solve the credit crisis.

A Queens-born graduate of New York University and the Harvard Business School, Mr. Paulson went to Wall Street in the early 1980s just as the biggest bull market in history was starting. He joined Bear Stearns in 1984 as a junior executive in the investment banking unit.

Ten years later, he started his hedge fund with $2 million of his own capital. During the technology-stock bubble of the late 1990s, Mr. Paulson took a negative stance on high-flying shares and profited handsomely for himself and his clients.

By the end of 2008, Mr. Paulson's assets under management had risen to $36.1 billion. In an early 2009 interview with The New York Times, Mr. Paulson talked about his success. "We are very proud of our performance last year," he said. "We provided an oasis of profitable returns for our investors in a year where there were few sources of gains."

His investors, which included pension funds, endowments, wealthy families and individuals, were huge beneficiaries of his strategy, Mr. Paulson added. "They made four times as much as we did," he said.

Mr. Paulson and his investment program was the subject of the 2009 book by Gregory Zuckerman "The Greatest Trade Ever." Mr. Zuckerman wrote that Mr. Paulson did not think there was anything wrong with working with various banks to create troubled investments that he could then bet against.

"Paulson told his own clients what he was up to and they supported him, considering it an ingenious way to grow the trade by finding more debt to short," Mr. Zuckerman wrote. "After all, those who would buy the pieces of any C.D.O. likely would be hedge funds, banks, pension plans or other sophisticated investors, not mom-and-pop investors."

Late last year, Mr. Paulson donated $20 million to the Stern School of Business at New York University and $5 million to Southampton Hospital in Long Island's East End, where he bought a $41 million home in early 2008. He lives with his wife and two daughters on the Upper East Side of Manhattan.

Amid criticism of investment strategies that profited from mortgage defaults, home foreclosures and other miseries, Mr. Paulson has also given $15 million to the Center for Responsible Lending for a center devoted to providing foreclosure assistance to troubled borrowers.

At the time of the donation, Mr. Paulson said of the center and its work, "We are pleased to help them provide legal services to distressed homeowners, many of whom have been victimized by predatory lenders."

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SATURDAY, APRIL 17, 2010

# A Wall Street Invention That Let the Crisis Mutate

JOE NOCERA
TALKING BUSINESS

Can it get any worse?

Every time you pick up another rock along the winding path that led to the financial crisis, something else crawls out. Subprime mortgages were sold as a way to give low-income people a chance at homeownership and the American Dream. Instead, the mortgages turned out to be an excuse for predatory lending and fraud, enriching the lenders and Wall Street at the expense of subprime borrowers, many of whom ended up in foreclosure.

The ratings agencies, which rated the complex investments that were built with subprime mortgages, turned out to be only too happy to be gamed by firms that paid their fees — slapping AAA ratings on mortgage bonds doomed to fail. Lehman Brothers turned out to be disguising the full reality of its horrid balance sheet by playing accounting games. All over Wall Street, firms pushed mortgage originators to churn out more loans that were doomed the moment they were made.

In the immediate aftermath, the conventional wisdom was that Wall Street had simply lost its head. It was terrible, to be sure, but on some level understandable: Dutch tulips, the South Sea bubble, that sort of thing.

In recent months, though, something more troubling has begun to emerge. In December, Gretchen Morgenson and Louise Story of The New York Times exposed the role that some firms, including Goldman Sachs and Deutsche Bank, played in putting together investment structures — synthetic C.D.O.'s, they were called — that were primed to blow up. They did so, reportedly, because some savvy investors wanted to go short the subprime market.

On Friday, the Securities and Exchange Commission dropped the hammer, charging Goldman Sachs with securities fraud for its purported failure to disclose that the bonds that were the basis for one particular synthetic C.D.O. had been chosen by none other than John Paulson, the billionaire hedge fund investor, who was shorting them.

Oh, and one other thing is starting to become clear: synthetic C.D.O.'s made the crisis worse than it would otherwise have been.

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Remember in the months leading up to the cri-

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The Goldman Sachs booth at the New York Stock Exchange on Friday. Shares of Goldman slid after the Securities and Exchange Commission accused the bank of fraud.

CHRIS HONDROS/GETTY IMAGES

*From First Business Page*

sis, when the Federal Reserve chairman, Ben Bernanke, and Henry Paulson Jr., then the Treasury secretary, were assuring everyone that the "subprime problem" could be contained? In truth, if the only problem had been the actual mortgage bonds themselves, they might have been right. At the peak there were well over $1 trillion in subprime and Alt-A mortgages that were securitized on Wall Street. That's a lot, to be sure — but it was a finite number. You could have only as much exposure as there were bonds in existence.

The introduction of synthetic C.D.O.'s changed all that. Unlike a "normal" collateralized debt obligation, which contained the bonds themselves, the synthetic version contained credit-default swaps — derivatives that "referenced" a particular group of mortgage bonds. Once synthetic C.D.O.'s became popular, Wall Street no longer needed to feed the beast with new subprime loans. It could make an infinite number of bets on the bonds that already existed.

And why did synthetic C.D.O.'s become popular? One reason was that the subprime companies were starting to run out of risky borrowers to make bad loans to — and hitting a brick wall. New Century, a big subprime originator, went bankrupt in early April 2007, for instance. Yet three weeks later, the Goldman synthetic C.D.O. deal, called Abacus 2007-ACI, went through, because it was betting on subprime mortgage bonds that already existed rather than bundling new ones. It didn't even have to go to the trouble of repackaging old C.D.O. tranches into new C.D.O.'s, which was also a common practice. (Goldman has vehemently denied any allegations of wrongdoing, pointing out that it lost $90 million on the particular Abacus deal that is the subject of the S.E.C. complaint.)

The second reason, though, is that synthetic C.D.O.'s gave people like John Paulson a way to short the subprime market. Mr. Paulson's bet against the subprime market, which famously reaped the firm billions in profits, was the subject of a recent book, "The Greatest Trade Ever." Boy, I'll say.

Both Gregory Zuckerman, the author of that book, and Michael Lewis, who wrote the current best seller "The Big Short," make it clear that the heroes of their narratives — the handful of people who had figured out that subprime mortgages were a looming disaster — were pushing Wall Street hard to give them a way to short the market. Maybe synthetic C.D.O.'s would have been created even without their urging, but it seems a little unlikely. They were the driving forces.

It is important to note that every synthetic C.D.O. required both investors who were long and others who were short. That is, there needed to be investors who believed the "referenced" bonds would rise in value, and others who believed they would fall. Everyone, on both sides of the transaction, understood that. What makes it feel like dirty pool is the allegation that Paulson & Company and Goldman Sachs were actively involved in choosing the bonds that would be bet on — knowing they were going to be short. In its filing on Thursday, the S.E.C. charged that Goldman never told investors of Mr. Paulson's involvement. "Credit derivative technology helped people disguise what they were doing," said Janet Tavakoli, the president of Tavakoli Structured Finance, and an early critics of many of the structures that have now come under scrutiny.

*Where every bad deal was a good one, to someone.*

There appear to be other examples of this, as well. Last week, Pro Publica, the nonprofit investigative journalism outfit, reported how a big Chicago hedge fund, Magnetar, helped put together some synthetic C.D.O.'s — precisely so that it could bet against them. In his book, Mr. Zuckerman seems to have stumbled onto Abacus and similar deals. One banker, he writes, "suspected that Paulson would push for combustible mortgages and debt to go into any C.D.O., making it more likely that it would go up in flames." Which is precisely what the S.E.C. is claiming. But in his quest to lionize his central character, Mr. Zuckerman rushes past what by all rights should have been the most shocking revelation in his book.

Mr. Lewis, for his part, recounts a dinner, late in the game, in which one of his heroes, Steve Eisman, is seated next to a man who is taking the long position on many of the C.D.O.'s he is shorting. They get to talking, and the man says to Mr. Eisman: "I love guys like you who short my market. Without you, I don't have anything to buy." He adds, "The more excited that you get that you're right, the more trades you'll do, the more product for me."

As a reader, it is hard not to love that moment, rich as it is in irony and foreboding. The guy on the long side — who was making investments that the housing and mortgage markets would remain strong — is an obvious fool; Mr. Eisman, on the short side the trade, is clearly going to be vindicated. (And, by Mr. Lewis's account, Mr. Eisman never "helped" a Wall Street firm pick the bonds for the C.D.O.'s he was shorting, the way the S.E.C. says Mr. Paulson did.)

But on second reading, the passage isn't quite so funny. The people on the short side of those trades were truly savvy investors, who, unlike so many others, did their homework and had insights that made them a great deal of money. But the rise of synthetic C.D.O.'s that they pushed for — and their ability to use credit-default swaps to short subprime mortgage bonds — took an already bad situation and made it worse.

And here we are now, all of us, paying the price.

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# For Goldman, A Deal's Stakes Keep Growing

## Fraud Case Resonates in Regulation Debate

By LOUISE STORY
and GRETCHEN MORGENSON

For Goldman Sachs, it was a relatively small transaction. But for the bank — and the rest of Wall Street — the stakes couldn't be higher.

Accusations that Goldman defrauded customers who bought investments tied to risky subprime mortgages have only just begun to reverberate through the financial world.

The civil lawsuit that the Securities and Exchange Commission filed against Goldman on Friday seemed to confirm many Americans' worst suspicions about Wall Street: that the game is rigged, the odds stacked in the banks' favor. It is the first big case — but probably not the last, legal experts said — to delve into a Wall Street firm's role in the mortgage fiasco.

It is a particularly sensitive time for Wall Street. Washington policy makers are hotly debating a sweeping overhaul of the nation's financial regulations, and the news could embolden those seeking to rein in the banks. President Obama on Saturday stepped up pressure for financial reform by accusing Republicans of "cynical and deceptive" attacks on the measure. [Page 22.]

The S.E.C.'s action could also hit Wall Street where it really hurts: the wallet. It could prompt dozens of investor claims against Goldman and other Wall Street titans that devised and sold toxic mortgage investments.

On Saturday, several European banks that lost money in the deal said they were reviewing the matter. They could try to recoup the money from Goldman.

And it raises new questions about Goldman, the bank at the center of more concentric circles of economic and political power

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BRENDAN McDERMID/REUTERS

The main office of Goldman Sachs in Lower Manhattan. The company could face a drawn-out, messy and public legal battle.

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than any other on Wall Street. Goldman — whose controversial success has leapt from the financial pages to the cover of Rolling Stone — has fiercely defended its actions before, during and after the financial crisis. On Friday, it called the S.E.C.'s accusations "unfounded."

Wall Street played a complex and, at times, seemingly conflicted role in the mortgage collapse. Goldman and others worked behind the scenes, bundling home loans into investments for sale to investors the world over. Even now, more than 18 months after Washington rescued the teetering financial system, no one knows for sure how much money was lost on those investments.

The public outcry against the bank bailouts was driven in part by suspicions that a heads-we-win, tails-you-lose ethos pervades the financial industry. To many, that Goldman and others are once again minting money — and paying big bonuses to their employees — is evidence that Wall Street got a sweet deal at taxpayers' expense. The accusations against Goldman may only further those suspicions.

"The S.E.C. suit against Goldman, if proven true, will confirm to people their suspicions about the total selfishness of these financial institutions," said Steve Fraser, a Wall Street historian and author of "Wall Street: America's Dream Palace." "There's nothing more damaging than that. This is way beyond recklessness. This is way beyond incompetence. This is cynical, selfish exploiting."

On Friday, Goldman's stock took a beating, falling 13 percent and wiping out more than $10 billion of the company's market value. It was a possible sign that investors fear that the S.E.C. complaint will damage Goldman's reputation and its ability to keep its hands on so many sides of a trade — a practice that is immensely profitable for the firm.

It is unclear whether the S.E.C. can prevail against Goldman. The bank has long maintained that it puts its clients first and, in a letter in its latest annual report, it reiterated that position. Goldman said it never "bet against our clients" in its trades but rather was trying to hedge against

*Graham Bowley and Jack Ewing contributed reporting.*

other trading positions.

The transaction cited in the S.E.C. complaint cost investors just over $1 billion, relatively small by Wall Street standards.

Still, Wall Street analysts said Goldman and other banks, having navigated the financial crisis, might now face a new kind of risk: angry investors. Most major Wall Street banks also created collateralized debt obligations, which are at the heart of the Goldman case. C.D.O.'s, which are essentially bundles of securities backed by mortgages or other debt securities, turned out to be among the most toxic investments ever devised.

"Any investor who bought these C.D.O.'s and lost a significant amount of money is probably looking at their investment and wanting to know: what were the details behind the sale?" said William Tanona, an analyst at Collins Stewart. "Will they contact the S.E.C. and say, 'Here's the transaction we participated in, and we'd love to know who is on the other side of it?'"

The biggest victim among investors, the S.E.C. complaint said, was the Royal Bank of Scotland, which inherited a loss of $841 million after it took over the Dutch bank ABN Amro. According to a person briefed on the matter, the Royal Bank, now controlled by the British government, is studying the documents but is not ready to decide whether to try to recoup money from Goldman.

The German bank IKB Deutsche Industriebank, as well as the German government, which in 2007 put up billions to prevent IKB from collapsing, still seemed to be sorting out who might have legal standing to pursue a possible claim.

Goldman faces a dilemma in its response. Wall Street firms tend to settle cases like this one, but Goldman's statement on Friday indicated it intended to dig in its heels and fight, perhaps in part to discourage suits by investors. That strategy could set it up for a long, messy and public battle.

The S.E.C. complaint named just one Goldman employee: Fabrice Tourre, a vice president in the bank's mortgage operation who worked on the questionable transaction.

But securities lawyers say Mr. Tourre appears to be a small fish. Federal investigators may try to gain his cooperation and extend their investigation to other Goldman employees. On Friday, Mr. Tourre's lawyer did not provide a comment on the complaint.

***A challenge for a bank that says it puts its clients first.***

A big question is how far up this might go. The S.E.C. said the deal in its complaint had been approved by a panel at Goldman, the Mortgage Capital Committee.

"It's typical that they'd start with someone lower down on the chain and try to exert pressure on that person," said Bradley D. Simon of Simon & Partners, a white-collar defense lawyer in New York. "Is it really conceivable that no one else was involved in this?"

RAMIN TALAIE/EUROPEAN PRESSPHOTO AGENCY

A Congressional panel has questioned Lloyd Blankfein, the chief executive of Goldman Sachs, about some of its products.

As the housing market began to fracture in 2007, senior Goldman executives began overseeing the mortgage department closely, said four former Goldman Sachs employees, who spoke on the condition they not be identified because of the sensitivity of the matter.

Senior executives routinely visited the unit. Among them were David A. Viniar, the chief financial officer; Gary D. Cohn, then the co-president; and Pablo Salame, a sales and trading executive, these former employees said. Even Goldman's chief executive, Lloyd C. Blankfein, got involved.

Top executives met routinely with Dan Sparks, the head of the mortgage trading unit, who retired in spring 2008. Managers instructed several traders to sell housing-related investments. Indeed, they urged Mr. Tourre and a colleague, Jonathan Egol, to place more bets against mortgage investments, the former employees said.

A Goldman spokesman said Saturday that the top executives were not involved in the approval process for Abacus, the deal cited by the S.E.C., and that their involvement with the mortgage department in 2007 was related to their desire to counterbalance the positive bets on housing the banks had already made.

Mr. Blankfein has already been questioned by a Congressional commission about the toxic vehicles Goldman devised and sold, even as the bank realized the housing market was in trouble.

Recent public statements made by Mr. Blankfein seem to conflict with the S.E.C. account.

In testimony in January before the Financial Crisis Inquiry Commission, the panel appointed by Congress to examine the causes of the crisis, for example, he described Goldman's approach to dealing with its clients: "Of course, we have an obligation to fully disclose what an instrument is and to be honest in our dealings, but we are not managing somebody else's money."

But the S.E.C. complaint says Goldman misled investors who bought one of the bank's Abacus deals. The bank failed to tell them the mortgage bonds underpinning the investment had been selected by a hedge fund manager who wanted to bet against the investment, the S.E.C. says. Those bonds were especially vulnerable, the commission says.

The New York Times

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# Top Leaders at Goldman Had a Role in Mortgages

## Ex-Employees Say Executives Kept Watch as Mortgage Unit Set Its Strategy

By LOUISE STORY

Tensions were rising inside Goldman Sachs.

It was late 2006, and an argument had broken out inside the Wall Street bank's prized mortgage unit — a dispute that would reach all the way up to the executive suite.

One camp of traders was insisting that the American housing market was safe. Another thought it was poised for collapse.

Among those who saw disaster looming were an effusive young Frenchman, Fabrice P. Tourre, and his quiet colleague, Jonathan M. Egol, the mastermind behind a series of mortgage deals known as the Abacus investments.

Their elite mortgage unit is now at the center of allegations that Goldman and Mr. Tourre, 31, defrauded investors with one of those complex deals.

The Securities and Exchange Commission filed a civil fraud suit on Friday that essentially says that Goldman built the financial equivalent of a time bomb and then sold it to unwitting investors. Mr. Egol, 40, was not named in the S.E.C.'s suit.

Goldman has vowed to fight the S.E.C. But the allegations have left many on Wall Street wondering how far the investigation might spread inside Goldman and perhaps beyond.

Pressure on Goldman mounted on Sunday as two members of Congress and Gordon Brown, Britain's prime minister, called for investigations into the bank's role in the mortgage market. Germany also said it was considering legal action against the bank. [Page B1.]

Mr. Tourre was the only person named in the S.E.C. suit. But according to interviews with eight former Goldman employees, senior bank executives played a pivotal role in overseeing the mortgage unit just as the housing market began to go south. These people spoke on the condition that they not be named so as not to jeopardize business relationships or to anger executives at Goldman, viewed as the most powerful bank on Wall Street.

According to these people, ex-

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ecutives up to and including Lloyd C. Blankfein, the chairman and chief executive, took an active role in overseeing the mortgage unit as the tremors in the housing market began to reverberate through the nation's economy. It was Goldman's top leadership, these people say, that finally ended the dispute on the mortgage desk by siding with those who, like Mr. Tourre and Mr. Egol, believed home prices would decline.

Lucas van Praag, a Goldman spokesman, said that senior executives were not involved in approving the Abacus deals. He said that the executives had sought to balance Goldman's positive bets on the mortgage market, rather than take an overall negative view.

Mr. Tourre, who now works for Goldman in London, declined to comment, as did Mr. Egol, Mr. van Praag said.

Mortgage specialists like those at Goldman were, in a sense, the mad scientists of the subprime era. They devised investments by bundling together bonds backed by home loans, a process that enabled mortgage lenders to make even more loans.

While this sort of financing helped make loans available, the most exotic creations also spread the growing risks inside the American housing market throughout the financial world. When the boom went bust, the results were disastrous.

By early 2007, Goldman's mortgage unit had become a hive of intense activity. By then, the business had captured the attention of senior management. In addition to Mr. Blankfein, Gary D. Cohn, Goldman's president, and David A. Viniar, the chief financial officer, visited the mortgage unit frequently, often for hours at a time.

Such high-level involvement was unusual elsewhere on Wall Street, where many executives spent little time learning the workings of their mortgage businesses or how those businesses might endanger their companies.

The decision to get rid of positive bets on mortgages turned out to be prescient. Unlike most other Wall Street banks, Goldman profited from its mortgage business as the housing bubble was inflating and then again when the bubble burst.

At the heart of all of this is the mortgage trading unit that, at its peak, employed several hundred people. As recently as 2007, Goldman's mortgage division was split into 11 subgroups, each with a specialty, according to an internal Goldman document that was provided to The New York Times by a former employee.

Together, these groups stood astride the nation's real estate market. One group, for instance, handled actual home loans. Another provided mortgage advice. A third syndicated loans among banks. And still another handled commercial real estate.

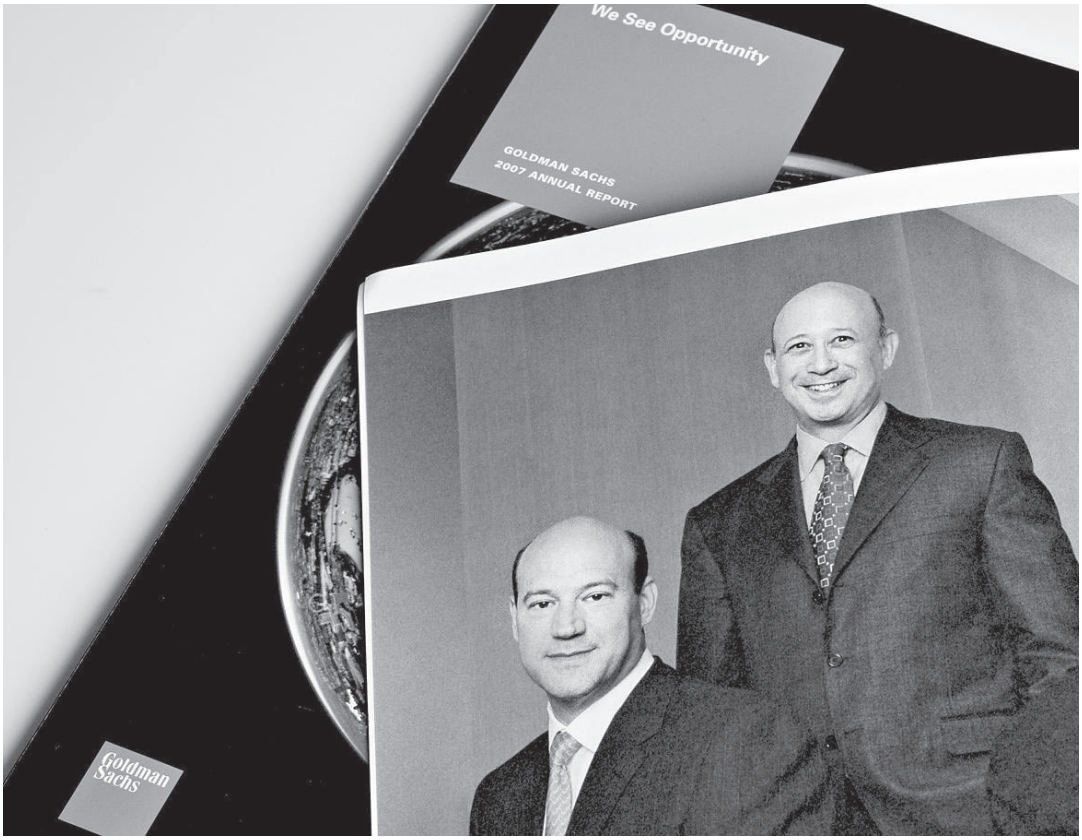
During the boom, Goldman's mortgage unit was a leader on Wall Street. In 2006 alone, the bank underwrote $26 billion of collateralized debt obligations, according to Dealogic, a financial data provider. Many C.D.O.'s have since turned out to be bad investments.

But in 2006, some inside Goldman began to worry about the fragile state of housing. Daniel L. Sparks, the Texan who ran the mortgage unit, sided with those who believed the market was safe. Two of his traders, Joshua S. Birnbaum and Michael J. Swenson, had placed a big bet that mortgage bonds would rise in value.

But this camp clashed with Goldman sales staff who were working with hedge funds that wanted to bet against subprime mortgages. Mr. Birnbaum told the team to stop promoting bets against some mortgage investments since such trades were hurting the market and Goldman's own position, according to two former Goldman employees.

But a few desks away, Mr. Tourre and Mr. Egol were quietly working on the Abacus deals.

They were, former colleagues say, something of an odd couple. A slight man with a flair for salesmanship, Mr. Tourre joined Goldman in 2001, after coming to the




DANIEL ACKER/BLOOMBERG NEWS

Gary Cohn, left, and Lloyd Blankfein appeared in a Goldman Sachs 2006 annual report.

United States to study business operations at Stanford. At Goldman, he courted investors like European banks and big hedge funds.

The taller Mr. Egol, a specialist in analytical finance with a quiet but sometimes intimidating demeanor, devised the Abacus investments. He came to Goldman after studying aerospace engineering at Princeton and finance at the Booth School of the University of Chicago.

What united them was an unusually negative view on the mortgage market. As far back as 2005, they clashed with Goldman traders who worked with big mortgage lenders like Countrywide to buy and package loans. Their Abacus deals included insurancelike protection that would pay out if certain mortgage bonds soured. Such credit-default swaps were not worth much in 2005, when housing was flying high, but became highly valuable once the market sputtered.

"Egol and Fabrice were way ahead of their time," said a former Goldman worker. "They saw the writing on the wall in this market as early as 2005."

Unlike many of their colleagues at Goldman and other banks, they argued that the nation's mortgage market was far more interconnected than believed, former Goldman employees said. Their view was that if one group of mortgages or mortgage bonds ran into trouble, the entire market might falter.

***The bank says leaders didn't approve deals faulted by the S.E.C.***

Mr. Tourre and Mr. Egol created a way for a prominent hedge fund manager, John A. Paulson, to bet against risky mortgages.

With Mr. Paulson's help, Goldman created an Abacus investment that, the S.E.C. now says, was devised to fall apart. By betting against that Abacus investment, Mr. Paulson reaped $1 billion in profit, according to the S.E.C. Mr. Paulson was not named in the S.E.C. complaint.

Goldman's top ranks changed its stance on housing in December 2006. In a meeting in a windowless conference room on the executive floor, Mr. Viniar, the chief financial officer, and Mr. Cohn, the president, gathered about 10 executives for a briefing. Mr. Sparks, the head of the mortgage unit, walked them through the numbers. The group was unanimous: Goldman had to reduce its exposure to the increasingly troubled mortgage market.

A few months later, in February 2007, senior executives began turning up on the trading floor. The message, one former employee said, was clear: management was watching.

"They basically said, 'What does this department do? Tell us everything about mortgages,'" this person said.

The executives told Mr. Sparks to tell his traders to sell Goldman's positive bets on housing. The traders' short positions — that is, negative bets, mostly used to hedge other investments — were placed in a central trading account.

Not everyone was happy about it. One trader leaving the firm wrote the mortgage unit a one-word e-mail message: "goodbye."

Goldman turned over all these negative positions to Mr. Swenson and Mr. Birnbaum, the traders who had previously been positive on the market. Along with Mr. Sparks, they have been credited for managing the short position that yielded a $4 billion profit for Goldman in 2007. Mr. Sparks retired in 2008. Mr. Birnbaum also left in 2008, to start his own hedge fund.

But former Goldman employees said those traders benefited from the short positions that were given to them. And their trading was tightly overseen by senior executives.

At one point in the summer of 2007, for instance, Mr. Birnbaum made a case to Mr. Cohn that some mortgage assets were cheap and that Goldman should let him add $10 billion in positive bets. Mr. Cohn said no.

Meantime, Goldman managers instructed Mr. Egol in early 2007 to add insurance against mortgage bonds.

By the third quarter of 2007, the mortgage unit was minting money, while Goldman's rivals were losing big.

Mr. Viniar, the chief financial officer, told analysts that the mortgage unit was posting record profits because of its short bets that mortgage investments would lose value.

"Our risk bias in that market was to be short, and that net short position was profitable," Mr. Viniar said.