



SEC Complaint Against Goldman Sachs

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Overview

- On Friday, April 16, the US Securities and Exchange Commission brought a civil action against Goldman Sachs in relation to a single transaction in 2007 involving two professional institutional investors, IKB and ACA Capital Management (ACA). We believe the SEC's allegations to be completely unfounded both in law and fact, and will vigorously contest this action.
- The core of the SEC's case is based on the view that one of our employees misled these two professional investors by failing to disclose the role of another market participant in the transaction, namely Paulson & Co., and that the employee thereby orchestrated the creation of materially defective offering materials for which the firm bears responsibility.
- Goldman Sachs would never condone one of its employees misleading anyone, certainly not investors, counterparties or clients. We take our responsibilities as a financial intermediary very seriously and believe that integrity is at the heart of everything that we do.
- Were there ever to emerge credible evidence that such behavior indeed occurred here, we would be the first to condemn it and to take all appropriate actions.
- This particular transaction has been the subject of SEC examination and review for over eighteen months. Based on all that we have learned, we believe that the firm's actions were entirely appropriate, and will take all steps necessary to defend the firm and its reputation by making the true facts known.
- The SEC does not contend that the two professional institutional investors involved did not know what they were buying, or that the securities included in this privately placed transaction were in any way improper. These institutions were very experienced in the CDO market.
- In this private transaction, Goldman Sachs essentially acted as an intermediary, helping to facilitate the investing objectives of two clients. Extensive disclosures as to each of the securities in the reference portfolio, similar to those required by the SEC in public transactions, were contained in the offering documents which provided all the information needed to understand and evaluate the portfolio.
- In the process of selecting the reference portfolio, ACA Capital Management, who was both the portfolio selection agent and the overwhelmingly largest investor in the transaction (\$951 million, with the other professional investor's exposure being \$150 million), evaluated every security in the reference portfolio using its own proprietary models and methods of analysis. ACA rejected numerous securities suggested by Paulson & Co., including more than half of its initial suggestions, and was paid a fee for its role as portfolio selection agent in analyzing and approving the underlying reference portfolio.
- In summary, the SEC's complaint is an issue of disclosure on a single transaction involving professional investors in a market in which they had extensive experience. Critical points missing from the SEC's complaint include:
 - **Goldman Sachs Lost Money on the Transaction.** The firm lost more than \$90 million arising from this transaction. Our fee was \$15 million. We certainly did not wish to structure an investment that was designed to lose money.
 - **Objective Disclosure Was Provided.** The transaction at issue involved a static portfolio of securities, and was marketed solely to sophisticated financial institutions. IKB, a large German Bank and leading CDO market participant and ACA Capital Management, the two investors, were provided extensive information about those securities and knew the associated risks. Among the most sophisticated mortgage investors in the world, they understood that a synthetic CDO transaction requires a short interest for every corresponding long position.
 - **Goldman Sachs Never Represented to ACA That Paulson Was Going To Be A Long Investor.** The SEC's complaint in part accuses the firm of potential fraud because it didn't disclose to one party of the transaction the identity of the party on the other side. As normal business practice, market makers do not disclose the identities of a buyer to a seller and vice versa. Goldman Sachs never represented to ACA that Paulson was to be a long investor.
 - **ACA, the Largest Investor, Selected and Approved the Portfolio.** The portfolio of mortgage backed securities was selected by an independent and experienced portfolio selection agent after a series of discussions, including with IKB and Paulson & Co. ACA had an obligation and, as by far the largest investor, every incentive to select appropriate securities.

Background

- In 2006, Paulson & Co. indicated its interest in positioning itself for a decline in housing prices. The firm structured a synthetic CDO through which Paulson could benefit from a decline in the value of the underlying reference securities. Those on the other side of the transaction, IKB and ACA Capital Management, the portfolio selection agent, could benefit from an increase in the value of the securities. ACA had a long established track record as a CDO manager. As of May 31, 2007, ACA was managing 26 outstanding CDOs with underlying portfolios consisting of \$17.5 billion of assets.
- IKB, ACA and Paulson all provided their input regarding the composition of the underlying securities. ACA ultimately and independently approved the selection of 90 Residential Mortgage Backed Securities (RMBS), which it stood behind as the portfolio selection agent and the largest investor in the transaction.
- The offering documents for the transaction included every underlying reference mortgage security. The offering documents for each of these RMBS in turn disclosed detailed information concerning the mortgages held by the trust that issued the RMBS.
- Any investor losses resulted from the massive decline of the broader subprime mortgage market, not because of which particular securities ended up in the reference portfolio or how they were selected.
- The transaction was not created as a way for Goldman Sachs to short the subprime market. To the contrary, Goldman Sachs retained a substantial long position in the transaction and lost money as a result.

Questions and Answers

Who were the investors in this transaction?

The investors in the transaction were ACA Capital Management, a well-recognized collateral manager and investor in CDOs, and IKB, then believed to be one of the most highly-sophisticated CDO investors in the world.

What is a synthetic CDO?

A synthetic CDO has characteristics much like that of a futures contract, requiring two counterparties to take different views on the forward direction of a market or particular financial product, one short and one long.

A CDO is a debt security collateralized by debt obligations, including mortgage-backed securities in many instances. These securities are packaged and held by a special purpose vehicle (SPV), which issues notes that entitle their holders to payments derived from the underlying assets. In a synthetic CDO, the SPV does not own the portfolio of actual fixed income assets that govern the investors' rights to payment, but rather enters into CDSs that reference the performance of a portfolio. The SPV does hold some separate collateral securities which it uses to meet its payment obligations.

What are the implications of this SEC action for the overall CDO market?

The SEC complaint is related to a single transaction in 2007 and involves a highly particularized set of alleged facts. It would not appear to have broad ramifications for the CDO market generally.

Who selected the securities that ended up in this particular portfolio?

ACA had the sole right and responsibility to select the portfolio and it in fact did so. As part of the process, ACA received input from other transaction participants. ACA had served as portfolio selection agent or collateral manager for numerous other transactions, and no doubt was accustomed to an interactive selection process. ACA used its own expertise and models in scrutinizing and approving the referenced securities. ACA subjected the securities proposed for inclusion in the portfolio to its own proprietary models and analysis.

What is the firm's role in facilitating such transactions?

Goldman Sachs acts as a market intermediary through which its clients can take long or short positions on the reference securities. Goldman Sachs will often assume the opposite side of a client's position to complete a transaction. As fully disclosed to investors in the offering materials in this transaction, the firm can then hold or sell that position to increase, reduce or eliminate its own exposures.

Did investors have adequate disclosure?

Extensive, objective disclosures were contained in the offering documents. Investors had all the information they needed to understand and evaluate the reference securities.

What was the role of ABN Amro / RBS in this transaction?

ABN intermediated a \$909 million credit default swap referencing the portfolio between Goldman Sachs and ACA. ABN assumed the credit risk that ACA might not be able to pay if its obligations under the credit default swap came due. When the portfolio suffered writedowns, ACA ultimately was not able to pay the amount due on the credit default swap, and ABN made payment.