Complex Derivatives

The Securities Exchange Commission in the U.S. sued Goldman Sachs in April, alleging securities fraud, making misleading statements, and failure to disclose material facts to investors while marketing a highly complex CDO (Collateralised Debt Obligation). Last month, the case was settled with Goldman agreeing to pay a fine of $ 550 mn, the largest ever by an investment bank, merely acknowledging that, it had made a “mistake” and that the offer documents had “incomplete information”. Given the large number of complex derivatives over which end-users have lost a lot of money in India and in many other countries, it would be interesting to look at the details of the case.

It starts when John Paulson approached Goldman with a proposal to structure and market a complex CDO. (Mr. Paulson is the hedge fund manager who made billions of dollars for his investors and himself, from the mortgage market crisis in the United States.) Mr. Paulson told Goldman that he had chosen the underlying debt obligations “for their high likelihood of default”, and intended to short the securities. (Mr. Paulson’s selection was impeccable: 83% of the underlying bonds were downgraded in 6 months and 99% in 9 months!) He also made clear that his “purpose in structuring the deal was to take a short position against the investments they were making.” (Both quotations from Financial Times editorial of April 17, 2010). Goldman brought in an independent credit advising firm, ACA Management, to vet the portfolio and, apparently, gave ACA an impression that Mr. Paulson intended to take a long position in the securities, exactly opposite to his purpose in structuring it, which purpose was known to Goldman. ACA allowed its name to be used and indeed wrote credit default swaps on the security. (It incurred a billion dollar loss when the deal soured shortly after it was structured and marketed.) Incidentally, last week the Reserve Bank has placed on its website the draft report of the Internal Group on Introduction of Credit Default Swaps (CDS) for Corporate Bonds for Public Comments.

Goldman was sued for failing to disclose in the marketing material or offer documents, that Mr. Paulson was involved in structuring the CDO which he was shorting; telling

investors that ACA, an independent RMBS (Residential Mortgage Backed Securities) expert had selected the portfolio; and for misleading ACA. Neither Mr. Paulson nor ACA were parties to the suit. This is the case which has now been settled with a fine and Goldman's admission of a "mistake". (In a less "sophisticated" era, Goldman's actions would have been described as "cheating".) The fine too was about half what observers were expecting, and the firm and its management escape from any criminal charges. The settlement was welcomed by investors and Goldman shares jumped up on its announcement. The case against the Goldman employee, Fabrice Tourre, involved in structuring the deal continues. But, as part of the settlement, Goldman has promised full co-operation with SEC in pursuing the case, even as it has agreed to bear his legal expenses! He obviously knew what he was doing. One of his emails produced in the case says that, "More and more leverage in the system, The whole building is about to collapse anytime now … Only potential survivor, the fabulous Fab … standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all of the implications of those monstrosities!!!"

Goldman is an investment bank which claims that it is "long term greedy"; in other words it does not look to quick gains. Its website emphasises the firm's commitment to its clients' interest in the following words: "Whether a mid-size employer is Kansas, a larger school district in California, a pension fund for skilled workers, or a start-up technology firm, our clients' interests come first." It also claims that the firm's core values are "team work, excellence and service to our clients".

At first sight, there is an obvious dichotomy and hypocrisy involved in the firm's claims of looking after client's interest and its actions at the heart of the SEC suit. Goldman's initial defence was that it sold CDOs only to sophisticated investors who required no protection: they knew, or at least should have known, what they were doing, the old doctrine of *caveat emptor*. In other words, such investors were "counterparties" and not customers or clients to whom it owed any duties! (The banks who lost huge sums in the investment included IKB in Germany and RBS in U.K., both subsequently rescued with public money. Citizens of Cedar Rapids, a small town in Iowa, are facing higher taxes because its treasurer invested in the CDO. Perhaps he was a sophisticated investor!) Goldman had also claimed that it did not "sponsor" the issue and was not obliged to endorse the quality of the investment.

Incidentally, Goldman is facing law suits also in U.K. and Germany, and an Australian hedge fund has claimed damages of a billion dollars in respect of another CDO (Timberwolf) in whose structuring and marketing Goldman was involved. Perhaps the only people to benefit by their dealings with Goldman are going to be lawyers!

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