

# THE INVESTMENT BANK JOB

## The U.S. Securities and Exchange Commission v. Goldman Sachs

**Andrew Schrieber**

On April 16, 2010, the Securities and Exchange Commission (SEC) charged Goldman Sachs and Vice President Fabrice Tourre with defrauding investment client ACA Management LLC (ACA) through the preparation and marketing of a financial product linked to subprime, or second-rate, mortgages. This financial instrument, entitled Abacus 2007-AC1 (Abacus), had been created specifically for an institutional client, John Paulson, the manager of the hedge fund Paulson & Company. When Goldman traders met with ACA they presented an array of possible mortgage investments from which ACA could select. As was made apparent in the subsequent S.E.C investigation, however, during its interactions with ACA, Goldman deliberately misled the company to believe that Paulson & Company was also investing in Abacus. In actuality, Paulson & Company was making the opposite investment wager, with the expectation that Abacus would lose money. Paulson's firm, with Goldman's assistance, was betting that the housing market would collapse.

Coming on the heels of the financial crisis, this behavior epitomized to many the erosion of integrity within the financial industry that had occurred following the regulatory reforms in the 1980s and late 1990s. Observers point to a number of changes over those decades that contributed to a fundamental, and negative, shift in internal practices and organizational culture. These changes include a shift from the partnership model toward the publicly traded bank and a loosening of governmental regulatory reins. This case study examines the evolution of the modern financial industry and the organizational and structural shifts within Wall Street banks that led to the case against Goldman Sachs.

The case and teaching notes for The Investment Bank Job: The U.S. Securities and Exchange Commission v. Goldman Sachs, by Andrew Schrieber, was completed under the direction of Dr. Rebecca Dunning, The Kenan Institute for Ethics.

*This work is licensed under the Creative Commons Attribution - Noncommercial - No Derivative Works 3.0 Unported License. To view a copy of this license, visit <http://creativecommons.org/licenses/by-nc-nd/3.0/>. You may reproduce this work for non-commercial use if you use the entire document and attribute the source: The Kenan Institute for Ethics at Duke University.*

## Introduction

In January of 2007, Goldman Sachs approached ACA Management LLC (ACA), an insurance firm, about placing an investment on one side of a financial wager. This financial instrument, entitled Abacus 2007-AC1, was tailored specifically for a familiar institutional client, John A. Paulson,<sup>1</sup> the manager of the hedge fund Paulson & Company. When Goldman traders met with ACA, they presented an array of possible mortgage investments from which ACA could select. As was made apparent in the subsequent SEC investigation, however, during its interactions with ACA, Goldman deliberately misled the company to believe that Paulson & Company was also investing in Abacus. In actuality, Paulson & Company was making the opposite investment wager, with the expectation that Abacus would lose money. Paulson's firm, with Goldman's assistance, was betting that the housing market would collapse.

In January of 2008, less than a year after the financial product's assemblage, 99% of the entire portfolio had been designated as virtually worthless. While Paulson pocketed \$1 billion from the arrangement, ACA and a co-investing bank, lost close to the same amount. On April 16, 2010, the Securities and Exchange Commission charged Goldman Sachs, and Vice President Fabrice Tourre with defrauding investors through a financial product linked to subprime mortgages.<sup>2</sup>

This case study analyzes this incident to provide perspective on the evolution of financial institutions since the Great Depression. The case considers the shifts in the regulatory landscape for finance, the change in the organizational structure of modern banks, and how this has transformed the role of financial institutions in modern society.

## A Fabled Firm's Foundations

In 1869, Marcus Goldman, an immigrant from Germany, began working in New York City making short-term loans to local merchants. Shortly following Samuel Sachs' marriage to Marcus Goldman's daughter, the two men founded the financial institution that would ultimately become known as Goldman Sachs. The firm would rise to prominence slowly, and it would even experience a major setback in the 1920s with the collapse of a Ponzi-esque scheme called the Goldman Sachs Trading Corporation. However, by 1956 Goldman Sachs had begun to assert its dominance in the financial marketplace by acting as the lead underwriter for the initial public offering (IPO) of Ford Motor Company.<sup>3,4,5</sup> Goldman Sachs held its own initial public offering in 1999, after having for many years been consistently at the top of Wall Street's rankings every single quarter.<sup>6</sup>

With the unofficial corporate mantra of "long-term greedy," inspired by the words of Goldman Sachs' managing partner in the 1960s, Gus Levy, Goldman has for decades tried to cultivate an image of ethical primacy amidst the

1 John A. Paulson bears no relation to Henry "Hank" M. Paulson, Treasury Secretary under President George W. Bush from July 2006 to January 2009. Immediately prior to that appointment, Henry Paulson had been the C.E.O. of Goldman Sachs for eight years.

2 As defined in Appendix A, the term subprime refers to a classification of borrowers with a tarnished or limited credit history.

3 For a more extensive look at the history of the firm, *The Wall Street Journal's* "Brief History of Goldman Sachs" is both informative and interactive. It is found online at: <http://online.wsj.com/article/SB10001424052748704671904575193780425970078.html?KEYWORDS=Goldman+Sachs>

4 See Appendix A for a basic overview of underwriting. Barron's *Dictionary of Finance and Investment Terms* defines an underwriter in two fashions. In dealing with insurance, an underwriter is a company that assumes the cost risk of death, fire, theft, illness, etc., in exchange for payments, called premiums. In dealing with securities, an underwriter is an investment banker who, singly or as a member of an underwriting group or syndicate, agrees to purchase a new issue of securities from an issuer and distribute it to investors, making a profit on the underwriting spread. 671.

5 See Appendix A for a basic overview of an IPO. Barron's *Dictionary of Finance and Investment Terms* defines an initial public offering as a corporation's first offering of stock to the public. IPO's are almost invariably an opportunity for the existing investors and participating venture capitalists to make big profits, since for the first time their shares will be given a market value reflecting expectations for the company's future growth. 280.

6 Kneeb, Jonathan A. *The Accidental Investment Banker: Inside the Decade that Transformed Wall Street*. 2<sup>nd</sup> ed. Random House, Inc., 2007. 24. For further updated information on Wall Street's "League Tables" visit [http://thomsonreuters.com/products\\_services/financial/](http://thomsonreuters.com/products_services/financial/)

cutthroat environment of Wall Street.<sup>7</sup> Even after the departure of Gus Levy from the firm, managing partners John Weinberg and John C. Whitehead solidified Goldman's image of integrity by establishing fourteen business principles. These fourteen principles, which also serve as the firm's mission statement of sorts, consist of succinct fundamental directives followed by a lengthier elaboration. For example, the first principle instructs Goldman employees that, "Our clients' interests always come first."<sup>8</sup> The principle is then justified with, "Our experience shows that if we serve our clients well, our own success will follow."<sup>9</sup>

## Toward Regulation

The modern configuration of Wall Street derives in large part from the complete regulatory overhaul by Congress and the F.D.R Administration in response to the Great Depression. From the early 1930s up until the beginning of the 1940s, federal legislators enacted a host of regulations that would fundamentally redesign Wall Street and define the financial industry for the next six decades.

On May 27, 1933 Congress passed the Securities Act of 1933, which was the first piece of legislation regulating the sale of securities and mandating federal registration of securities in the primary market.<sup>10,11,12</sup> Less than a month later, on June 16, Congressmen Carter Glass and Henry B. Steagall introduced a sweeping piece of financial reform legislation, the Banking Act of 1933, commonly referred to as the Glass-Steagall Act.<sup>13</sup> Most notably, the legislation established the Federal Deposit Insurance Corporation, and prohibited any organizational fusion between commercial and investment banking units as well as insurance firms.

Almost one year later, on June 6, 1934, Congress passed the Securities Exchange Act of 1934, which established the Securities and Exchange Commission.<sup>14</sup> The commission was charged with regulating the trading of securities in the secondary market, for instance through the employment of dealers or brokers. A parallel extension to this legislation would come two years later, on June 15, 1936, with the Commodity Exchange Act. This law would directly

---

7 Levy's adage served as the source of inspiration for Nils Lindskoog's work *Long Term Greedy: The Triumph of Goldman Sachs*, written in 1999.

8 Goldman Sachs' Business Principles can be found in Appendix C of this case study, or online at: <http://www2.goldmansachs.com/our-firm/our-people/business-principles.html>

9 In conjunction with these guiding principles, Goldman Sachs established a "Code of Business Conduct and Ethics," in accordance with the Sarbanes-Oxley Act. This can be found on the firm's website at: <http://www2.goldmansachs.com/our-firm/investors/corporate-governance/corporate-governance-documents/bus-cond-ethics.pdf>

10 Landis, James M. "The Legislative History of the Securities Act of 1933." *George Washington Law Review*. 28.29 (1959): 29.

11 See Appendix A for a basic overview of a security. Barron's *Dictionary of Finance and Investment Terms* defines a security in multiple manners, however there are only two definitions wholly relevant to this case study. A *financial security* is collateral offered by a debtor to a lender to secure a loan called collateral security. For instance, the security behind a mortgage loan is the real estate being purchased with the proceeds of the loan. If the debt is not repaid, the lender may seize the security and resell it. An *investment security* is an instrument that signifies an ownership position in a corporation (a stock), a creditor relationship with a corporation or governmental [not sure why there's a dash in governmental, but didn't want to take it out in case this is a direct quote] body (a bond), or rights to ownership such as those represented by an option, subscription right, and subscription warrant. 551.

12 See Appendix A for a basic overview of both primary and secondary markets. Barron's *Dictionary of Finance and Investment Terms* defines a primary market as a market for new issues of securities, as distinguished from a secondary market, where previously issued securities are bought and sold. A market is primary if the proceeds of sales go to the issuer of the securities sold. The term also applies to government securities auctions and to opening option and futures contract sales. 468.

13 Isaac, William M., and Melanie L. Fein. "Facing the Future – Life Without Glass-Steagall." *Catholic University Law Review*. 37.281 (1987): 281.

14 Tracy, John E., and Alfred Brunson MacChesney. "The Securities Exchange Act of 1934." *Michigan Law Review*. 32.8 (June 1934): 1025.

regulate all commodities and futures trading, and it mandated that all of these stock options had to be traded on stock exchanges.<sup>15,16,17,18</sup>

The next decade would bring even more financial regulatory legislation, as Congress passed the Investment Company Act of 1940 on August 22, 1940. By requiring firms to disclose relevant information about their finances, the legislation addressed potential conflicts of interest and acted as a public safeguard.<sup>19</sup> Similarly, Congress also passed the Investment Advisers Act of 1940, which augmented the federal oversight of individual financial advisors.<sup>20</sup> Specifically, this act mandated that investment advisers had a legally binding fiduciary duty to act in the best interest of their clients. In particular this included the legal responsibility to deal with clients in good faith, to release all material facts when dealing with clients, and to make all attempts to not mislead clients.<sup>21</sup>

## The Carter, Clinton, and Reagan Revolution

After this complete financial overhaul, regulatory financial legislation remained relatively stagnant until the 1970s. In 1974 the Commodity Futures Trading Commission was created to more effectively enforce the Commodity Exchange Act and to preempt the then infantile field of exotic financial derivatives.<sup>22,23</sup> The following year, a particularly notable regulatory shakeup occurred when the Securities and Exchange Commission eliminated fixed trading commissions in the stock market.<sup>24,25</sup> For Wall Street, this was particularly troubling because it meant that there would no longer be a set trading fee, and the banks would have to contend with and compete for increasingly lower base fees per trade. The day the regulation took effect was even termed “Mayday,” in reference to the month that the directive took effect and as an insinuation of the distress that Wall Street felt at the time.<sup>26</sup> Overnight, a staple of the finance industry’s guaranteed profit source was reduced to virtually nothing, as newer firms would compete to drive down the cost of stock brokerage to pennies.

15 Stein, William L. “The Exchange-Trading Requirement of the Commodity Exchange Act.” *Vanderbilt Law Review*. 41.473 (1988): 473.

16 See Appendix A for a basic overview of a stock option. Barron’s *Dictionary of Finance and Investment Terms* defines a stock option as a right to purchase or sell a stock at a specified price within a stated period. Options are a popular investment medium, offering an opportunity to hedge positions in other securities, to speculate in stocks with relatively little investment, and to capitalize on changes in the market value of options contracts themselves through a variety of options strategies. 599.

17 As defined in Appendix A, a commodity is any good exchanged during commerce, which includes goods traded on a commodity exchange.

18 See Appendix A for a basic overview of a futures contract. Barron’s *Dictionary of Finance and Investment Terms* defines a futures contract as an agreement to buy or sell a specific amount of a commodity or financial instrument at a particular price on a stipulated future date. A futures contract obligates the buyer to purchase the underlying commodity and the seller to sell it, unless the contract is sold to another before settlement date, which may happen if a trader waits to take a profit or cut a loss. 230.

19 Tolins, Richard B. “Investment Company Act of 1940.” *Cornell Law Quarterly*. 26.77. (1940): 77.

20 Lovitch, Fred B. “The Investment Advisers Act of 1940 – Who Is an ‘Investment Adviser?’” *University of Kansas Law Review*. 24.67 (1975): 67.

21 The Securities and Exchange Commission provides a detailed legislative breakdown of the Investment Advisers Act of 1940 in Release No. 1889 posted on their website on August 3, 2000. The release can be found at: <http://www.sec.gov/litigation/admin/ia-1889.htm>

22 Murphy, Elizabeth M., and Martin White. United States. *Securities and Exchange Commission [Release No. 33-9123; File No. 265-26]*. DC: Federal Register, 13 May 2010.

23 See Appendix A for a basic overview of a derivative. Barron’s *Dictionary of Finance and Investment Terms* defines a derivative as a contract whose value is based on the performance of an underlying financial asset, index, or other investment. For example, an ordinary option is a derivative because its value changes in relation to the performance of an underlying stock. A more complex example would be an option on a futures contract, where the option value varies with the value of the futures contract which, in turn, varies with the value of an underlying commodity or security. Derivatives are available based on the performance of assets, interest rates, currency exchange rates, and various domestic and foreign indexes. 147.

24 “Wall Street: Prosperity Blunts ‘Mayday’s’ Edge.” *Time*. 28 Apr 1975: 1.

25 As defined in Appendix A, a fixed trading commission is a fixed service charge assessed by a broker or investment advisor in return for handling the trade itself.

26 McGee, Suzanne. *Chasing Goldman Sachs: How the Masters of the Universe Melted Wall Street Down*. 1<sup>st</sup> Edition. New York City, New York: Crown Business, 2010. 58.

The regulation that resulted in “Mayday” would prove to be one of the last rules put in place that seemingly hampered the activity on Wall Street. Indeed, Wall Street would enjoy almost four decades of sustained deregulation, beginning with President Carter. In 1980, the Depository Institutions Deregulation and Monetary Control Act was passed. This piece of legislation increased the limit of the amount of needed deposit insurance from \$40,000 to \$100,000, while phasing out the ceilings on interest rates.<sup>27</sup> The scrapping of interest rate ceilings would directly increase the competitive pressure on banks, while the increased amount of insurance required for a commercial bank led to a heightened sense of trust in those banks. Bolstered by the deregulatory changes enacted under President Carter and galvanized by the Reagan Revolution underfoot, Wall Street lobbied fiercely and successfully for increased deregulation of the financial industry. What resulted, in December of 1982, was the Garn-St. Germain Depository Institutions Act.<sup>28</sup> This legislation effectively removed many of the restrictions on real estate lending and loosened the limits on lending to individual borrowers.<sup>29</sup>

The decades long deregulatory push culminated in the enactment of two pieces of legislation that would have far-reaching implications for the financial industry. On November 12, 1999, the Financial Services Modernization Act of 1999 went into effect. This law repealed part of the Glass-Steagall Act of 1933, specifically the rules separating banking operations, and opened up the market for banks to have joint-run ventures consisting of any hybrid of commercial or investment banking and insurance.<sup>30</sup> After breaching the regulatory wall between commercial and investment banking, Congress would next decide to simply not regulate most over-the-counter derivatives through the enactment of the Commodity Futures Modernization Act of 2000. This piece of legislation, for all intents and purposes, exempted the entire derivatives market from federal regulation.<sup>31</sup>

## The Fall of the Partnership and Rise of the Publicly Traded Bank

Since their inception, investment banks had operated as private partnerships composed of varying numbers of partners. Partners were individuals who were recognized as the top brass at their firm and were selected annually by senior leaders who had already been accepted into and collectively comprised a firm’s partnership. Under the partnership model, all of the firm’s capital belonged to the partners because new partners would bring capital with them upon joining the partnership.<sup>32</sup> This collective pool of capital would be invested and deployed on deals at an individual level but would be monitored by the partnership as a whole.

Inasmuch as partners’ life savings would be on the line with every financial transaction taken, there was a huge incentive to monitor every trade and investment to ensure that it was prudent. Outsized risk taking was virtually nonexistent because a single misjudgment or simple miscalculation could threaten the partnership’s entire stake in the firm. Correspondingly, since bonuses were tied to and allocated from the total amount of money that the partnership doled out at the end of each year, there was no gaming of the system or excessive leveraging of the firm’s reserves for personal gain. While there are accounts of brawls that would erupt around the holidays when it came time to distribute out the year’s bonuses, the partnership structure of the firm generally kept everyone accountable and playing by the rules. What is more, bonuses themselves were tied to performance review evaluations that were handwritten by a partner’s fellow co-workers.<sup>33</sup>

27 Allen, Paul R., and William J. Wilhelm. “The Impact of the 1980 Depository Institutions Deregulation and Monetary Control Act on Market Value and Risk: Evidence from the Capital Markets.” *The Journal of Money, Credit and Banking*. 20.3 (August 1988, Part 1): 364.

28 Cornett, Marcia Millon, and Hassan Tehranian. “An Examination of the Impact of the Garn-St. Germain Depository Institutions Act of 1982 on Commercial Banks and Savings and Loans.” *The Journal of Finance*. 45.1 (March 1990): 95.

29 Wenzel, Mark. “The Credit Bubble: Deregulation Gone Wild.” *Seeking Alpha* 06 Apr 2008: 1.

30 Akhigbe, Algebe, and Ann Marie Whyte. “The Market’s Assessment of the Financial Services Modernization Act of 1999.” *The Financial Review*. 36.4 (2001): 119-138.

31 Taibbi, Matt. “Wall Street’s Big Win.” *Rolling Stone*. 4 Aug 2010: 3.

32 McGee, 62.

33 Ellis, Charles D. *The Partnership: The Making of Goldman Sachs*. 2<sup>nd</sup> Edition. New York City, New York: Penguin Books, 2009. 177.

As the size of Wall Street's banks began to grow in scale and scope of activity, the partnership model began to increasingly lose its luster as more and more capital was needed to fund and facilitate financial transactions. In Europe, mammoth commercial banks, like Deutsche Bank and Credit Suisse, were edging in on the international competition that had begun to emerge over new flourishing markets, such as the one for Eurobonds.<sup>34</sup> Banks realized that they would need access to larger and permanent reserves of capital to compete and to build up their operations globally, the likes of which only outside investors could provide.<sup>35,36</sup>

Then in 1970, the New York Stock Exchange repealed the ban that restricted banks from being traded publicly on an exchange.<sup>37</sup> This provided a timely opportunity for bankers to access desired investment capital. In April of that year, an investment bank by the name of Lufkin & Jenrette held their initial public offering and began to trade publicly for \$15 a share.<sup>38</sup> While privately resisted for years, the first occurrence of a bank having their own initial public offering would have a domino effect on the rest of the financial industry. One by one the largest institutions on Wall Street would all hold their own initial public offerings and would become publicly traded companies beholden to their shareholders. In 1971 Merrill Lynch went public, followed by Bear Stearns in 1985, Morgan Stanley in 1986, Lehman Brothers in 1994, and finally Goldman Sachs in May of 1999.<sup>39</sup>

This singular momentous event—the conception of the publicly traded bank—signaled the beginning of a paradigm shift in the realm of banking and finance. With the permanent influx of capital came a shift in priorities and accountability for the banks. With shareholders now the party to whom a financial firm was chiefly held accountable, Wall Street's concern increasingly shifted towards satisfying shareholders with huge returns every quarter.<sup>40</sup>

Thus, a firm's return on equity became the driving force behind bankers' activity. Critics of these developments have noted that the social cohesion that existed under the partnership model largely dissolved, and bankers became beholden to an external force that demanded ever-increasing returns. Rather than defer to clients or build up a relationship over several successive years, bankers progressively relied more on short-term transactions that were risk intensive.<sup>41</sup> Ultimately, this activity would generate a vicious feedback loop wherein shareholders came to expect positive returns every quarter.<sup>42</sup>

## Wall Street's Wizardry, Hailing from Academia

This heightened pressure from shareholders and increased intra-firm competition drove the banks on Wall Street to devise increasingly sophisticated and complex financial products that could garner larger returns. As more and more of the Wall Street banks went public, and as trading fees dwindled subsequent to the SEC elimination of fixed trading commissions, banks increasingly looked for new, innovative, and more profitable financial products to market to their institutional clients.

The intermediary functions of banks, including underwriting, advising on mergers and acquisitions, as well as even the basic sales and trading, only brought in huge profits for firms and shareholders when they could be performed in large volumes, such as during the dot-com bubble.<sup>43</sup> From the 1950s to the early 1980s, fees from structured and

---

34 Ibid, 67.

35 Ibid, 84.

36 Ellis, 578.

37 Davidoff, Steven M. "Did Going Public Spoil the Banks?." *The New York Times*. 22 Aug 2008, Global Edition Business Day: 1.

38 McGee, 64.

39 Gross, Daniel. "The Gang of Five, and How They Nearly Ruined Us." *Slate*. 29 Jan 2010: 1.

40 McGee, 84.

41 Ellis, 584.

42 Cassidy, John. "What Good is Wall Street?." *The New Yorker*. 29 Nov 2010: 4

43 McGee, 55.

more complex financial products never resulted in more than 20% of total bank revenues.<sup>44</sup> Financial firms began to panic as the elimination of fixed fees from trading commissions gnawed at their traditional means of generating profits.

Then, Wall Street's white knights emerged, armed with a simple theory that would have profound implications for the next four decades of banking activity. Hailing from a seemingly unorthodox source, the Massachusetts Institute of Technology, Professors Fischer Black and Myron Scholes concocted a financial formula that could correctly and accurately estimate the price of a stock option.<sup>45</sup> Devised in 1973, the Black-Scholes model provided a level of security and consistency in the financial marketplace that had never before existed. Now traders could strategically map out ways to make trading their stock options viable and immensely profitable and packaged it in a way that the trader's strategy could be sold to investors.<sup>46</sup>

With the guesswork of pricing a stock option virtually eliminated, traders could not only accurately approximate the costs involved with their financial transactions, but they could also conceive trades that would entail virtually no monetary risk.<sup>47</sup> The stability that this introduced into the marketplace could drive down the costs of transactions and potentially augment financial innovation.<sup>48</sup> Since any stock option could be accurately priced, traders began to attach stock option prices to everything from interest ratings to energy prices and even weather patterns.<sup>49</sup>

These new financial products, termed derivatives, were the perfect fee-generating solution that Wall Street firms needed to satiate shareholder's ravenous appetite for consistent returns every quarter. Indeed, by the end of the 1990s, approximately 40% of a bank's revenue derived from fees associated with financial products, namely derivatives.<sup>50</sup>

## The Institutional Ascendance of Sales and Trading

Armed with these new financial innovations and with the continued pressure from shareholders for quarterly profits Wall Street began to turn increasingly towards more inherently risky activities that had the potential to return huge payoffs. While investment banking services such as underwriting and offering institutional advice to clients on prospective mergers generated consistent revenues for Wall Street banks, there was a potential for heightened returns through increased activity in the more speculative division of sales and trading. Another type of activity commonly undertaken by investment banks, sales and trading, involves buying and selling any type of financial product on behalf of a client or for the firm's own account. This would prove to be exactly the type of activity that shareholders would clamor for as year over year returns increased parallel to the growth of sales and trading as a percentage of a bank's revenue generating activity.

Goldman Sachs did not go public until 1999 and was thus not beholden to shareholders prior to that year; however, it presciently recognized the pivotal role that sales and trading could play in boosting profit margins. Back in 1981, Goldman acquired J. Aron & Company, a commodities and futures trading firm that was particularly active in the South American markets for both gold and coffee.<sup>51</sup> Two months after Goldman went public, it purchased Hull Trading Company, an electronic trading company that had expertise in trading derivatives.<sup>52</sup> One year later, in

44 Ibid.

45 Ellis, 407.

46 McGee, 66.

47 Ellis, 408.

48 Ibid, 400.

49 Ibid, 408.

50 McGee, 55.

51 Vault Inc., *Goldman Sachs Vault employer profile*. 2004 Edition. Pennsylvania State University: Vault, 2004. 6.

52 Kahn, Joseph. "Goldman Sachs to Acquire Electronic Trading Concern." *The New York Times*. 13 Jul 1999, Technology: 1.

September of 2000, Goldman would then go on to purchase Spear, Leeds, & Kellogg, a financial firm that specialized in New York Stock Exchange trading.<sup>53</sup>

While Goldman Sachs expanded its trading operation relentlessly through the later decades of the 20<sup>th</sup> century, it was the acquisition of the commodities trading firm J. Aron in 1981 that would serve as the organizational launch pad for the firm's increased reliance on sales and trading as a means of revenue generation. In 1992, for the first time in the modern history of the firm, Goldman revealed to the public a handful of numbers that were indicative of the means by which it made its money. While in 1989 investment-banking services had been the source of 35% of Goldman's revenues, the percentage declined to 16% in 1993.<sup>54</sup> This trend would continue throughout the next two decades as investment-banking accounted for only 14.9% of Goldman's revenues in 2006 and a meager 9.3% in the first quarter of 2010.<sup>55</sup> Comparably, fees from the management of mergers and acquisitions declined from 40% of Goldman's revenues in the tail end of the 1980s to 17% of total revenues by 1993.<sup>56</sup>

While the percentage of revenue derived from these traditional activities at Goldman continued to slide, the speculative functionality of J. Aron became increasingly dominant. In 1990, more than 40% of Goldman's revenue came from the trading firm. Similarly, in 1991, around 33% of the firm's revenue was derived from J. Aron's trading venture. In stark contrast to the continued decline of the firm's traditional, conservative banking responsibilities, between 2006 and the first quarter of 2010, Goldman Sachs' share of revenue from Trading and Principal activities rose from 67.9% to 80.2% of their total revenue.<sup>57</sup> Thus, the acquisition of J. Aron eventually served to enhance the profitability of Goldman Sachs as it supplanted the historic means by which the firm made money.

The J. Aron subsidiary also served as Goldman's incubator for the firm's future leadership. As the percentage of sales and trading activity within Goldman Sachs began to rise meteorically, the firm's top leadership began to hail increasingly and originally from J. Aron. The current Chairman and CEO of Goldman, Lloyd Blankfein, as well as the President and COO, Gary Cohn, both began their Goldman careers at J. Aron.<sup>58</sup> With Blankfein at the helm of Goldman's operations, sales and trading activity increased directly in response to and as a result of the firm's increase in revenues. Prior to the financial crisis and at the height of Wall Street profitability and Blankfein's reign, Goldman Sachs was bringing in revenues of \$46 billion annually, three times larger than what the firm generated in 2000.<sup>59</sup>

The J. Aron trader mentality carried over into the policies of the overall firm as J. Aron alumni assumed senior leadership positions. Risk-taking was championed as a means of inter- and intra-firm advancement, short-term yields were prized, and maximizing returns became the firm's overarching operational mantra.<sup>60</sup> When Goldman was acquiring J. Aron, the commodities trading firm was often described as a Wild West of frenzied activity and crass, unapologetically competitive behavior.<sup>61</sup> Upon Blankfein's rise to the top post within the firm, this attitude directly translated into a policy shift wherein Goldman setup profiles for every banker to track how much money they were earning for the firm.<sup>62</sup> As with trading operations, electronic leader-boards were setup on Goldman's computer databases to monitor individual performance, and to systematically rank and prioritize employees into over- and

53 Andrews, John, and Kate Baum. "Spear, Leeds & Kellogg Joins With Goldman Sachs." *Goldman Sachs Press Release*. 11 Sep 2000.

54 Endlich, Lisa. *Goldman Sachs: The Culture of Success*. 2<sup>nd</sup> Edition. New York City, New York: Touchstone, 2000. 131.

55 Correspondent. "Trading regime: Goldman Sachs, revenue %," from "Goldman Sachs: Bombmakers Bombarded." Financial. *The Economist*. Web. Accessed on 20 Jul 2010. Found online at: <http://media.economist.com/images/images-magazine/2010/29/fn/201029fnc815.gif>

56 Endlich, 131.

57 See Footnote <sup>50</sup>.

58 McGee, 229.

59 McLean, Bethany. "The Bank Job." *Vanity Fair*. Jan 2010: 10.

60 McGee, 229.

61 Endlich, 96.

62 Anderson, Jenny. "As Goldman Thrives, Some Say an Ethos Has Faded." *The New York Times*. 15 Dec 2009, Global Edition Business Day: 1.



underperformer categories. While the top firm breadwinners were rewarded handsomely with million dollar bonuses, in many years, such as in 2008, the bottom 5% of employees would be critically evaluated and likely fired.<sup>63</sup>

Critics contended that the enactment of such hypercompetitive policies promoted a ruthless work environment that treasured profits above any other indicator of success. Indeed, the inability to generate sufficient profits for the firm, at any cost, could literally have cost an individual their livelihood. It is in this setting that the narrative of this case study begins.

## Betting on Failure

In early 2006, Wall Street had coalesced around a common, extraordinarily profitable, cause. The housing market was defying the laws of economics, and virtually everyone from the chief investment bankers to the top financial scholars thought that the American economy had entered into a new era of sustained growth. Under this guise, securities firms established the ABX mortgage securities index.<sup>64,65</sup> This index was much like a traditional stock exchange except that it was tailored specifically to allow traders to bet on the likelihood that the housing market would go up or down.<sup>66</sup> This exchange would serve as the platform for extravagant speculations on the American housing market, including the financial product arranged by Goldman Sachs as detailed in this case study.

At the tail end of 2006, analysts in Goldman Sachs' mortgage unit were at odds as to what direction the United States housing market was going to take. One side pointed to the consistent historical rise in housing prices in every decade following the Second World War.<sup>67</sup> The opposing faction highlighted distress signals within the broader economy that indicated the weakening foundation underlying the housing market. Many in this contrarian camp even suspected, correctly, that there was a housing bubble developing. Chief amongst these prescient bankers were two individuals, Jonathan M. Ego and Fabrice P. Tourre, who persuasively employed their economic data as a rallying cry for betting against the housing market.

On December 14, 2006, the leadership at Goldman Sachs made their first moves in identifying the ensuing economic malaise embedded in the United States housing market. For two and a half hours, David Viniar, the Chief Financial Officer at Goldman Sachs, walked the firm's top executives, risk managers, traders, and mortgage underwriters, through the development of the housing bubble.<sup>68</sup> Viniar pored through the consistent, daily losses in Goldman's mortgage portfolio, with particular emphasis on a ten-day stretch of losses that was indicative of something amiss

---

63 Harper, Christine. "Goldman May Fire 1,500 Workers in Annual Review." *Bloomberg Businessweek*. 25 Jan 2008.

64 A more in-depth description of the ABX Index is provided below: "The ABX Index is a series of credit-default swaps based on 20 bonds that consist of subprime mortgages. ABX contracts are commonly used by investors to speculate on or to hedge against the risk that the underlying mortgage securities are not repaid as expected. The ABX swaps offer protection if the securities are not repaid as expected in return for regular insurance-like premiums. A decline in the ABX Index signifies investor sentiment that subprime mortgage holders will suffer increased financial losses from those investments." This information was accessed online at: [http://housingderivatives.typepad.com/housing\\_derivatives/abx\\_index/](http://housingderivatives.typepad.com/housing_derivatives/abx_index/)

65 The ABX Index is administered by the Markit Group, a financial information services business. More information about their administration of the ABX index can be found online at: <http://www.markit.com/en/products/data/indices/structured-finance-indices/abx/abx.page>

66 Morgenson, Gretchen, and Louise Story. "Banks Bundled Bad Debt, Bet Against It and Won." *The New York Times*. 23 Dec 2009, Global Edition Business Day: 2.

67 Davis, Morris A., and Jonathan Heathcote. "The price and quantity of residential land in the United States." *Journal of Monetary Economics*. 54.8 (Nov 2007): 2595-2620.

68 McGee, 373.

in the housing market, particularly relating to residential mortgage-backed securities (RMBS).<sup>69,70,71</sup> At this time, Goldman had already underwritten and sold off billions of dollars of these specific mortgage-based securities that had been rated as investment grade by ratings agencies.<sup>72</sup> By some estimates, Goldman Sachs had sold more than \$40 billion worth of securities, backed by 200,000 subprime, or inferior, home mortgages between 2006 and 2007.<sup>73</sup> Though once bullish on the housing market, Viniar's presentation convinced the firm that the housing market was indeed over-inflated and had developed into a housing bubble. The most profitable course of action was to bet against it.<sup>74</sup>

This meeting had immediate implications for every division within Goldman Sachs handling residential mortgage-backed securities. Virtually all of the traders promptly took short positions on the ABX index, betting against the housing market.<sup>75</sup> The firm would spend the next several months purging their books of any risky and subprime mortgage securities. From the time of the December 2006 meeting to February of 2007, Goldman Sachs effectively sold off \$11 billion worth of subprime and risky mortgage securities.<sup>76,77</sup>

## Formulating High Finance

Under the inventive leadership of Egol, the firm then went one step further. Assuming that the firm's prediction about the impending collapse of the housing market was correct, Goldman Sachs began to arrange financial products with subprime residential mortgage-backed securities that were selected intentionally to compose a product designed to perform poorly. Since 2004 Egol had been quietly brainstorming and then orchestrating the development of financial products intended to capitalize on the housing market implosion. Rather than simply betting heavily against the housing market itself, Egol sought to use a new mortgage-based variant of a decades-old financial product called a collateralized debt obligation (CDO).<sup>78</sup>

Beginning in early 2006, Goldman tailored these collateralized debt obligations to be "synthetic," indicating that they had no underlying security and were essentially pure financial speculation. Thus, Goldman was the intermediary setting up a gambling wager between the equity or "long" side that wagered that the housing prices would continue to rise and the "short" side which bet that housing prices would decrease. The financial speculation derives from the entity which takes the short side in a credit default swap (CDS) and thus agrees to pay back the interest

69 Cohan, William D. "The Rage Over Goldman Sachs." *Time*. 31 Aug 2009: 2.

70 Gordon, Greg. "How Goldman secretly bet on the U.S. housing crash." *McClatchy Newspapers* 1 Nov 2009, McClatchy Washington Bureau: Part 1, 3.

71 See Appendix A for a basic overview of an RMBS. The Securities and Exchange Commission defines residential mortgage-backed securities as debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization. A more detailed definition can be found online at: <http://www.sec.gov/answers/mortgagesecurities.htm>

72 Cohan, 4.

73 Gordon, 1.

74 McGee, 373.

75 McLean, 13.

76 Gordon, 4.

77 In a document prepared for the Securities and Exchange Commission, Goldman Sachs explains both their prophetic meeting that was held to discuss the issues pertaining to the housing market and the firm's subsequent responses. The report is entitled *Goldman Sachs: Risk Management and the Residential Mortgage Market*. 24 Apr 2010. 5. This report can be found on Goldman Sachs' website at: <http://www2.goldmansachs.com/our-firm/on-the-issues/risk-man-doc.pdf>

78 Around the country subprime mortgage lenders were extending out home loans to tens of thousands of individuals who could not afford the mortgages. Firms like Goldman Sachs would then collect these mortgages by the thousands and bundle them into a security called a mortgage-backed bond. Following this, banks would collect multiples of these same types of securities and bundle them into an even larger financial product, which is called a collateralized debt obligation.

owed to the long investor.<sup>79</sup> In turn, the long investor consents to pay back the underlying principal of the CDO if it defaults.<sup>80</sup> Between 2004 and 2008, Ego would coordinate 25 such deals, entitled Abacus, with a combined total value of \$10.9 billion.<sup>81</sup>

## Executing Abacus

Around the same time as the Goldman Sachs meeting at the end of 2006, John A. Paulson, the president and founder of the hedge fund Paulson & Company, had analyzed the housing markets and settled upon a comparable negative view of the market as had Goldman Sachs. Cognizant of the CDO market and the potential for a windfall if his prediction about the housing market was indeed correct, Paulson identified 123 residential mortgage-backed securities that his hedge fund expected to decline rapidly in value.<sup>82</sup> In particular, Paulson zeroed in on Triple B rated residential mortgage-backed securities that all had high percentages of adjustable rate mortgages. Additionally, Paulson analyzed and selected mortgages that were concentrated in states such as Nevada, Florida, California, and Arizona, all of which had recently seen high rates of house price appreciation.<sup>83</sup> Paulson & Company had teased out some of the lowest rated, most unstable mortgage-backed securities in the market, ones which they believed held higher investment ratings than the mortgages actually deserved.<sup>84</sup>

Armed with this slew of risky securities, Paulson approached Goldman Sachs to structure a synthetic collateralized debt obligation based off of the securities the hedge fund had selected. What resulted was Abacus 2007-AC1.<sup>85</sup> In keeping with his vision of the housing market, Paulson intended to short, or bet against, the CDO, wagering that housing prices were going to decrease. Goldman placed the necessary credit default swap insurance on the mortgage-backed securities.<sup>86</sup> All that was needed to complete the transaction was another party willing to take the opposite long side of the gamble.<sup>87</sup>

The requisite equity party, or “long,” for the transaction appeared in early January of 2007. Goldman Sachs went to ACA and proposed that their firm be the portfolio selection agent for the financial transaction sponsored by Paulson.<sup>88</sup> Following this successful gauge of interest, on January 8 Fabrice Tourre, a mid-level vice president at Goldman Sachs who managed the Abacus 2007-AC1 transaction, held a meeting with a representative from Paulson’s hedge fund and an ACA representative to discuss the financial product. In Paulson’s office in New York City the three firm representatives talked over the structure of the collateralized debt obligation, as well as the intended roles of all of the parties involved.<sup>89</sup>

---

79 As defined in Appendix A, a credit default swap is a trade designed to transfer the credit exposure of fixed income products between parties.

80 Quirk, William J. “Too Bad Not to Fail.” *The American Scholar*. Summer 2010. (2010): 2.

81 Morgenson, 2.

82 Phillips, Andrew Garcia, “Middlemen: How Goldman Sachs structured the deal under scrutiny.” *The Wall Street Journal*. Web. Accessed on 30 Oct 2010. This info-graphic derived from the S.E.C. Complaint can be found online at: <http://online.wsj.com/public/resources/documents/info-enlargePic07.html?project=imageShell07&bigImage=SECGOA-WSJ-100417.gif&h=696&w=950&title=WSJ.COM&thePubDate=20080826>

83 Calamari, Andrew M., Richard E. Simpson, and Reid A. Muoio. United States. *Securities and Exchange Commission v. Goldman Sachs & Co. and Fabrice Tourre Securities Fraud Complaint*. DC: United States District Court, Southern District of New York, 2010. 9.

84 Story, Louise, and Gretchen, Morgenson. “S.E.C. Accuses Goldman of Fraud in Housing Deal.” *The New York Times*. 16 Apr 2010, Global Edition Business: 2.

85 Calamari, 6.

86 Story, 2.

87 For a financial transaction involving a synthetic collateralized debt obligation such as this, there does not need to be a person taking both the short and long sides of the transaction. All parties could invest alongside each other. However, for Paulson’s trade to work, since this financial product had no real assets underlying it, there needed to be a counter-party actually investing in the equity of the CDO.

88 Calamari, 8.

89 Ibid, 9.

Two days later, on January 10, Tourre emailed his transaction working group at ACA and reinforced the roles that everyone would play. Tourre's email details how Goldman Sachs, "wanted to summarize ACA's proposed role as 'Portfolio Selection Agent' for the transaction that would be sponsored by Paulson (the 'Transaction Sponsor')."90 Following this email, on January 12, Tourre called the representatives from ACA over the phone to further formalize the relationship between the three participating entities. By this point ACA began to have some reservations about the setup of the arrangement and expressed some confusion and uneasiness about the arrangement that Tourre had proposed. Indeed, on January 14 ACA sent an email to a sales representative from Goldman Sachs inquiring about the involvement that Paulson & Company had devised for this financial transaction. The main part of the email expressed the fundamental confusion on the part of ACA:

"I certainly hope I didn't come across too antagonistic on the call with Fabrice [Tourre] last week but the structure looks difficult from a debt investor perspective. I can understand Paulson's equity perspective but for us to put our name on something, we have to be sure it enhances our reputation."<sup>91</sup>

This email was subsequently forwarded to Tourre on January 16. At this point Tourre was intimately aware that ACA thought that Paulson was taking a long position in the CDO, rather than betting against the financial product, which was his actual intention. Indeed, ACA was actually under the impression that Paulson had also invested \$200 million in the equity of Abacus 2007-AC1 due to suggestions made by Goldman Sachs.<sup>92</sup> This false impression was further corroborated on a meeting held on February 2 between representatives from the three firms, as Tourre spun a tale of the two firms co-investing. At the same meeting, Tourre even sent out a short message to a co-worker at Goldman Sachs declaring,

"I am at this aca paulson meeting this is *surreal*."<sup>93</sup>

After this series of meetings was concluded, on February 26, ACA and Paulson & Company reached an agreement on 90 residential mortgage-backed securities for Abacus 2007-AC1.<sup>94</sup> Outside of the meetings, Goldman Sachs was simultaneously developing marketing materials that presented the Abacus financial product as having only been selected by ACA. On February 26, Goldman released a nine-page term sheet concerning Abacus 2007-AC1 that stated how the residential mortgage-backed securities had been "selected by ACA."<sup>95</sup> The term sheet made no reference to Paulson. On the same day, Goldman also made available a 65-page flip book that devoted 28 pages to describing ACA'S business philosophy and investment strategies, as well as a section ensuring investors that the party that selected the financial product portfolio had an "alignment of economic interest" with the respective investors.<sup>96</sup> As with the term-sheet, there was no mention of Paulson in the flipbook.<sup>97</sup> However, ACA and Goldman Sachs' logos were prominently displayed on virtually every page of the flipbook.<sup>98</sup>

On March 12, senior Goldman Sachs leadership formally approved the Abacus transaction. That same day, Goldman released an internal memorandum stating that, "Goldman is effectively working an order for Paulson to buy protection on specific layers of the ABACUS 2007-AC1 capital structure."<sup>99</sup> Contrary to the marketing materials produced for the investors and potential investors in Abacus, this memo explicitly acknowledged the preferential

90 Ibid.

91 Ibid, 15.

92 Ibid, 2.

93 Ibid, 10.

94 Ibid, 11.

95 Ibid.

96 Ibid, 12.

97 Citation for the flipbook prepared by Goldman Sachs and ACA Management: *Abacus 2007-AC1 \$2 Billion Synthetic CDO Referencing a static RMBS Portfolio Selected by ACA Management, LLC*. Produced by Goldman Sachs, ACA Management, LLC. 26 Feb 2007.

98 Zuckerman, Gregory, Susanne Craig, and Serena Ng. "Goldman Sachs Charged with Fraud." *The Wall Street Journal*. 17 Apr 2010: 4.

99 Calamari, 13.

role that Goldman had afforded Paulson in this transaction, and how the financial product was arranged by and for his hedge fund to bet against. On April 26, 2007, Goldman formalized and finalized the deal. The firm released a 178-page memo that included the oft-repeated description of ACA as the “Portfolio Selection Agent,” and no reference or mention of Paulson & Company.<sup>100</sup>

Later that same day, the Abacus deal closed out and Goldman Sachs received compensation of \$15 million in fees for arranging the transaction. Apart from managing the CDO, ACA directly invested \$42 million into the financial product and was liable for another \$900 million by insuring the specific portions of the CDO that Paulson & Company bet against.<sup>101</sup> Additionally, toward the end of the structuring of the financial transaction, a German industrial bank, IKB, decided to invest \$150 million in Abacus as well, after having done seemingly minimal analysis of the CDO.<sup>102</sup>

By October 24, 2007, 83% of the mortgage-based securities had been downgraded. By January 29, 2008, 99% of the entire CDO portfolio had been downgraded and designated as virtually worthless. As a direct result, ABN Amro, the parent holding company of ACA, lost \$840,909,090 and IKB lost approximately \$150 million in the transaction.<sup>103</sup> Conversely, Paulson pocketed \$1 billion from the arrangement.<sup>104</sup>

A little over two years later, on April 16, 2010, the Securities and Exchange Commission charged Goldman Sachs and Vice President Fabrice Tourre with “defrauding investors by misstating and omitting key facts about a financial product tied to subprime mortgages as the U.S. housing market was beginning to falter.”<sup>105</sup>

## Goldman’s Defense: Taking Fiduciary Duty into Account

Goldman Sachs responded to the Security and Exchange Commission’s allegations in part by stating that it also lost \$90 million in the financial transaction, and it did not structure a portfolio that was intentionally designed to fail. Back in September of 2009, when the SEC originally contacted Goldman Sachs about the potential lawsuit that the financial watchdog agency was considering, Goldman responded with two letters that would foreshadow their defense when the lawsuit went to court. In direct response to the allegation that Goldman had devised a financial product explicitly intended to fail, the law firm representing it, Sullivan & Cromwell, wrote in one of the letters that the implosion of the housing market was not a guaranteed occurrence.<sup>106</sup> Indeed, the law firm went on to argue that the SEC was making their case against Goldman with perfect hindsight.<sup>107</sup> In addition, the firm and financial insiders would claim that there was a huge market appetite for these types of financial products at the time, and in consequence Goldman Sachs did not arbitrarily concoct this CDO.<sup>108</sup>

Further, it stated that all of the parties involved consisted of consenting adults and mature counterparties who all had a firm handling of the financial instruments involved. By extension, Goldman explained their role as market-makers

---

<sup>100</sup> Ibid, 12.

<sup>101</sup> Surowiecki, James. “The Billion-Dollar Question in the Goldman Deal.” *The New Yorker*. 21 Apr 2010.

<sup>102</sup> Surowiecki, James. “Fraud and Fecklessness on Wall Street.” *The New Yorker*. 19 Apr 2010.

<sup>103</sup> Calamari, 3.

<sup>104</sup> Stoll, Ira. “Goldman Sachs, John Paulson, And ‘The Fabulous Fab’.” *Seeking Alpha*. 16 Apr 2010: 1.

<sup>105</sup> Reisner, Lorin L., Kenneth R. Lench, and Reid A. Muoio. United States. *SEC Charges Goldman Sachs With Fraud in Structuring and Marketing of CDO Tied to Subprime Mortgages*. DC: S.E.C., 2010. 1.

<sup>106</sup> Klapper, Richard H., Michael T. Tomaino, Jr., and Christopher J. Dunne. United States of America before the Securities and Exchange Commission. *In the Matter of ABACUS CDO File No. HO-10911*. New York City: Attorneys for Goldman, Sachs & Co., 2009. 9.

<sup>107</sup> Appelbaum, Binyamin. “A Difficult Path in Goldman Case.” *The New York Times*. 19 Apr 2010: 2.

<sup>108</sup> E. Rasiel, Duke Financial Economics Center, Durham, NC, personal communication, 2010.

and how it was not playing an advisory role that would entail any fiduciary duty to any of their counterparties.<sup>109,110</sup> The firm's letter to the SEC from September 2009 elaborated on this concept:

“Consistent with one of the fundamental ethical standards governing their conduct, broker-dealers do not have to disclose their clients' positions or strategies to other parties with whom they engage in trades.”<sup>111,112</sup>

Rather than acting as an adviser to the various parties involved in the transaction, Goldman contended that it was simply making a market in the securities and their role was to act as the middle-man seeking out parties on the buy and sell sides of the transaction.<sup>113</sup> Indeed, the CEO of Goldman Sachs, Lloyd Blankfein, argued that market-makers do not owe any fiduciary duty to their clients and that their sole responsibility is to ensure that the clients with whom they are working attain the level of risk exposure that they have requested.<sup>114</sup>

## Postscript

Just months after the Securities and Exchange Commission launched their legal assault against Goldman Sachs, the two parties came to an agreement out of court. To settle the lawsuit, Goldman made a historic payout on July 15, 2010 of \$550 million to the SEC, the largest fine paid to the watchdog organization in United States history.<sup>115</sup> However, Goldman Sachs did not concede that it violated any laws or regulations governing Wall Street. In a public statement addressing the resolution of the case, the firm stated that, “Goldman will not admit wrongdoing, though it will admit that its marketing materials for the investment contained incomplete information.”<sup>116</sup>

Internal to Goldman Sachs, the settlement with the SEC also stipulated that the firm must undergo remedial action to reevaluate the way that employees conduct themselves in accordance with business practices. Additionally, the SEC mandated that Goldman employees receive special educational training in preparing and presenting marketing materials to institutional clients. On their own, Goldman decided to administer an entire organizational investigation into how the firm approaches and behaves in respect to industry and business standards.<sup>117</sup> Moreover, the recent passage of the Dodd-Frank Act, President Obama's financial reform initiative, took into account much of the behavior of Goldman Sachs that precipitated the SEC lawsuit.<sup>118</sup>

While Goldman Sachs has settled their lawsuit with the Securities and Exchange Commission, the settlement did not cover the principal actor involved. Fabrice Tourre stands accused of having knowingly given Goldman Sachs “substantial assistance” in deceiving investors throughout the production and marketing of Abacus 2007-AC1.<sup>119</sup> As of January 1, 2011, the personal suit lodged against Tourre remains unresolved.

---

109 As defined in Appendix A, a market-maker is a broker-dealer firm that accepts the risk of holding a certain number of shares of a particular security in order to facilitate trading in that security. Barron's *Dictionary of Finance and Investment Terms* details how market-makers must maintain firm bid and offer prices in a given security by standing ready to buy or sell generally accepted unit of trading on a securities exchange at publicly quoted prices. 341.

110 Detailed in: *Goldman Sachs: Risk Management and the Residential Mortgage Market*. Prepared for the Securities and Exchange Commission. 24 Apr 2010. 2.

111 Klapper, 46.

112 The term “broker-dealer” can be substituted with the expression “market-maker” considering the context in which Mr. Blankfein is employing the term in this statement.

113 Gross, Daniel. “Goldman's Social License.” *Slate*. 30 Apr 2010: 2.

114 Correspondent. “The Goldman Hearings: Sachs and the Shitty.” *Finance. The Economist*. 29 Apr 2010: 2.

115 Sorkin, Andrew Ross. “Goldman Settles With S.E.C. for \$550 Million.” *The New York Times*. 15 Jul 2010, Dealbook: 1.

116 Ibid.

117 Ibid, 3.

118 Correspondent. “A Price Worth Paying.” *New York. The Economist*. 15 Jul 2010: 2.

119 Gallu, Joshua. “Goldman Sachs's Tourre Facing New Claim in SEC Lawsuit.” *Bloomberg Businessweek*. 24 Nov 2010.

## Appendix A

Key Financial Terms (arranged in order of appearance within case study)

**Underwriting:** The process by which investment bankers raise investment capital from investors on behalf of corporations and governments that are issuing securities.

**Initial Public Offering (IPO):** The first sale of stock by a private company to the public. IPOs are often issued by smaller, younger companies seeking the capital to expand, but can also be done by large privately owned companies looking to become publicly traded.

**Securities:** A contract that can be assigned a value and traded.

**Primary Market:** A market that issues new securities on an exchange.

**Secondary Market:** A market where investors purchase securities or assets from other investors rather than from issuing companies themselves.

**Stock Options:** A privilege, sold by one party to another, which gives the buyer the right, but not the obligation, to buy or sell a stock at an agreed-upon price within a certain period or on a specific date.

**Commodities:** Any good exchanged during commerce, which includes goods traded on a commodity exchange.

**Futures:** A financial contract obligating the buyer to purchase an asset or the seller to sell an asset, such as a physical commodity or a financial instrument, at a predetermined future date and price.

**Derivatives:** A security whose price is dependent upon or derived from one or more underlying assets. The derivative itself is merely a contract between two or more parties. Its value is determined by fluctuations in the underlying asset.

**Fixed trading commission:** A fixed service charge assessed by a broker or investment advisor in return for handling the trade itself.

**Residential Mortgage-Backed Securities (RMBS):** A type of security whose cash flows come from residential debt such as mortgages, home-equity loans, and subprime mortgages.

**Subprime:** A classification of borrowers with a tarnished or limited credit history.

**Collateralized Debt Obligation:** (CDO) An investment-grade security backed by a pool of bonds, loans and other assets.

**Credit Default Swap:** (CDS) A swap designed to transfer the credit exposure of fixed income products between parties.

**Market-Maker:** A broker-dealer firm that accepts the risk of holding a certain number of shares of a particular security in order to facilitate trading in that security.

**Source:** <http://www.investopedia.com/dictionary/>

## Appendix B

Timeline of Events: From Goldman Sachs' senior meeting concerning the housing market leading up to S.E.C. lawsuit.

**December 14, 2006:** David Viniar, Goldman Sachs' Chief Financial Officer, holds a two and a half hour meeting talking senior leadership through the unstable U.S. housing market.

**Late December 2006 / Early January 2007:** Hedge fund manager John Paulson settles on similarly negative view of the housing market; his fund Paulson & Company selects 123 RMBS that they expect to lose value rapidly.

Paulson approaches Goldman Sachs about arranging a CDO with the selected RMBS that his hedge fund can bet against.

**Early January 2007:** Goldman Sachs approaches ACA about investing in Paulson's CDO, entitled Abacus.

**January 8, 2007:** Meeting between Fabrice Tourre and representatives from ACA and Paulson & Company about structure of CDO and each firm's involvement.

**January 10, 2007:** Tourre sends email indicating Paulson will be the "Transaction Sponsor"; ACA will be the "Portfolio Selection Agent."

**January 14, 2007:** ACA representative sends an email to Goldman Sachs writing and mistakenly believing that Paulson & Company would invest alongside ACA.

**February 2, 2007:** Meeting between the three involved parties reaffirming unfounded roles; Tourre sends out an email to a co-worker about how the meeting was "surreal."

**February 26, 2007:** Goldman Sachs and ACA release a nine-page term sheet and 65-page flipbook about Abacus; there is no mention of Paulson's role in selecting the underlying RMBS in Abacus.

**March 12, 2007:** Senior leadership at Goldman approve the CDO; Goldman sends out an internal memo stating that it is "working an order for Paulson to buy protection on...ABACUS," counter to what ACA understood or had been told.

**April 26, 2007:** Abacus deal closes; Goldman releases memo again referencing ACA as the "Portfolio Selection Agent"; there is no mention of Paulson's role.

By **October 24, 2007:** 83% of the RMBS comprising Abacus had been downgraded.

By **January 29, 2008:** 99% of the RMBS comprising Abacus had been downgraded and designated as virtually worthless; ABN Amro, the parent holding company of ACA, loses a total of \$840,909,090; IKB, a German bank, loses approximately \$150 million; Paulson & Company collects \$1 billion.

**April 16, 2010:** Securities and Exchange Commission charges Goldman Sachs and Vice President Fabrice Tourre with defrauding investors.

**July 15, 2010:** Goldman Sachs settles with the Securities and Exchange Commission for \$550 million; it does not admit wrongdoing; Tourre not covered in the settlement.



## Appendix C

### Goldman Sachs' Fourteen Business Principles

#### **1. Our clients' interests always come first.**

Our experience shows that if we serve our clients well, our own success will follow.

#### **2. Our assets are our people, capital and reputation.**

If any of these is ever diminished, the last is the most difficult to restore. We are dedicated to complying fully with the letter and spirit of the laws, rules and ethical principles that govern us. Our continued success depends upon unswerving adherence to this standard.

#### **3. Our goal is to provide superior returns to our shareholders.**

Profitability is critical to achieving superior returns, building our capital, and attracting and keeping our best people. Significant employee stock ownership aligns the interests of our employees and our shareholders.

#### **4. We take great pride in the professional quality of our work.**

We have an uncompromising determination to achieve excellence in everything we undertake. Though we may be involved in a wide variety and heavy volume of activity, we would, if it came to a choice, rather be best than biggest.

#### **5. We stress creativity and imagination in everything we do.**

While recognizing that the old way may still be the best way, we constantly strive to find a better solution to a client's problems. We pride ourselves on having pioneered many of the practices and techniques that have become standard in the industry.

#### **6. We make an unusual effort to identify and recruit the very best person for every job.**

Although our activities are measured in billions of dollars, we select our people one by one. In a service business, we know that without the best people, we cannot be the best firm.

#### **7. We offer our people the opportunity to move ahead more rapidly than is possible at most other places.**

Advancement depends on merit and we have yet to find the limits to the responsibility our best people are able to assume. For us to be successful, our men and women must reflect the diversity of the communities and cultures in which we operate. That means we must attract, retain and motivate people from many backgrounds and perspectives. Being diverse is not optional; it is what we must be.

#### **8. We stress teamwork in everything we do.**

While individual creativity is always encouraged, we have found that team effort often produces the best results. We have no room for those who put their personal interests ahead of the interests of the firm and its clients.

#### **9. The dedication of our people.**

The dedication of our people to the firm and the intense effort they give their jobs are greater than one finds in most other organizations. We think that this is an important part of our success.

#### **10. We consider our size an asset that we try hard to preserve.**

We want to be big enough to undertake the largest project that any of our clients could contemplate, yet small enough to maintain the loyalty, intimacy and the esprit de corps that we all treasure and that contribute greatly to our success.

**11. We constantly strive to anticipate the rapidly changing needs of our clients and to develop new services to meet those needs.**

We know that the world of finance will not stand still and that complacency can lead to extinction.

**12. We regularly receive confidential information as part of our normal client relationships.**

To breach a confidence or to use confidential information improperly or carelessly would be unthinkable.

**13. Our business is highly competitive, and we aggressively seek to expand our client relationships.**

However, we must always be fair competitors and must never denigrate other firms.

**14. Integrity and honesty are at the heart of our business.**

We expect our people to maintain high ethical standards in everything they do, both in their work for the firm and in their personal lives.

**Source:** <http://www2.goldmansachs.com/our-firm/our-people/business-principles.html>