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Why Goldman Sachs committed Fraud.

In 2010, the investment banking firm *Goldman Sachs* and its Vice President Fabrice Tourre were charged by the *Security and Stock Exchange Commission* (SEC) for fraud by false representation. The SEC accused Goldman Sachs for misrepresenting information in a deal between *ACA Management LLC* (ACA) and *Paulsen & Company*. Essentially, the SEC believed that Goldman had deliberately withheld critical information from ACA in order to convince them to invest in one of Goldman’s complicated financial instruments which was known as *Abacus-AC1* (Abacus). When the case was brought to court, Goldman defended themselves by stating that their role as a market-maker “would not entail any fiduciary duty to any of their counterparties” (Schrieber, page 14). While this argument can be classified as partially successful, Goldman eventually settled the lawsuit with a $550 million payment to the SEC, I will try to offer an explanation to why Goldman should have indeed been charged with fraudulent conduct. To do so, I will first examine the definition of fraud. More specifically, I will analyze the three key components that define fraudulent behavior and then relate them to the Goldman case.

Generally speaking, fraud is defined as the material misrepresentation of information that is made available with an intent to deceive that causes harm to a party that has come to rely upon that information. To me, three points stand out. First, fraud always involves some kind of wrong information. Second, there is an intent to deceive. And third, a party gets harmed due to this misinformation because they believed it to be true.  
In Goldman’s case, the evidence is strong and clear that the behavior of Tourre and other Goldman employees during meetings with ACA was dishonest and deceptive. To understand why, we need to look a little closer at how the financial instrument Abacus works. On paper, Abacus is a synthesized collateral debt obligation (CDO). In layman’s terms, this means that in contrast to a traditional CDO, which is basically a mortgage-backed security that ideally generates continuous cash flows through interest and principal payments, a synthetic CDO does not have actual underlying assets. In other words, a synthetic CDO lacks the “physical backbone” of a classic CDO. Moreover, to invest in a synthetic CDO, you always need two counterparties. One side bets on the synthetic CDO, in this case on the housing market, and the other party bets against it. And that is what happened in 2007. Paulsen & Company approached Goldman with the intent to take a gamble against the housing market and to invest into Abacus. Goldman’s responsibility was it to find the second party needed to complete the deal. A couple weeks after this request from Paulsen, Goldman and ACA started negotiations about a possible interaction in this arrangement. However, during these negotiations, Goldman made it seem like Paulsen and ACA were both betting on the housing market. For instance, after one of these negotiation meetings, an ACA representative reached out to a Goldman employee via email and stated that Paulson’s equity position would seem understandable, but the structure of Abacus looked difficult from a debt investor perspective (Schrieber, page 12). Cleary, this suggests that ACA was not aware that Paulson was actually betting against them. They thought that both parties were on the same side of the bet. This demonstrates that Goldman portrayed the situation completely different than it actually was. Therefore, they misrepresented the details of the Abacus deal to ACA.

Second, we need to ask whether Goldman intentionally withheld this crucial information from ACA. To be honest, I believe that this question can only be answered definitely by those people who were in the negotiation rooms at the time. However, at the time the culture at Goldman Sachs, as well as the traditions at most Wall Street investment banks, strongly implies that the Goldman employees were worried mainly about getting the deal between Paulsen and ACA done. In the early 2000s, banks were constantly competing for new clients, new revenue streams. The times in which the overwhelming majority of banks were registered partnerships, bank employees were genuinely concerned about the performance of their clients’ portfolios, and banking firms were not traded publicly was long over. Pushed by outside investors and the demands of the modern financial markets, publicly traded banks like Goldman Sachs were always seeking short-term yield and maximized profits. It was this development that caused the creation of more and more complicated financial instruments. Instead of successfully managing their clients’ money, banks started to mainly market and sell their services and products to customers. Financial instruments like the Abacus were a direct consequence of this development. The more complex and entangled a service or offering was, the better for the bank since they could charge hidden or unexpected fees to their inattentive clients. I claim that something along these lines happened during the meetings between ACA and Goldman. Goldman employees were trying to sell a service, not matter the cost to meet company revenue goals or individual performance bench marks. This can also be seen by the fact that Goldman and Sachs had identified the mortgage backed securities as highly risky investments back in 2006. Everybody at Goldman was told to sell as much MBS as they could and bet against the housing market if possible. Therefore, I wonder why a company would consider selling a product to an entity if the entire organizations believes that the product will not perform well. To me, it only makes sense to conclude that Goldman was purely trying to collect service fees from the transaction. Hence, I believe that Goldman employees intentionally withheld details to ACA so they would become part of the deal.

Lastly, we need to address the question of whether ACA got harmed specifically because they took Goldman’s intentionally incomplete (or even wrong) information for true. I think that out of the three key points of fraud mentioned above, this one is arguably the hardest to prove. In the end, the synthetic CDO could have performed fine from ACA’s perspective and Paulsen could have lost all its money. In other words, if it was impossible for Goldman to predict market movements, how can they be held accountable for the outcome of the transaction? To be fair, even though this question sounds reasonable, it distracts from the actual issue. The true problem is not that ACA lost a lot of money on a complicated bet. The true problem is the fact that ACA allocated money to Abacus based on the fractional information Goldman did provide to them. Therefore, we need to ask whether ACA would have invested into Abacus if they would have been made aware that they are gambling with party which has analyzed the housing market and identified it to be a about to fall apart. Maybe. But probably not. At ACA, they probably got blinded by Goldman Sachs’ reputation as one of Wall Streets’ most credible institutions and did not do their own due diligence work on the investment as carefully as they should have. However, that does not free Goldman from any responsibility. ACA agreed to the deal based on the information given to them and this information was incomplete due to Goldman’s actions. Therefore, Goldman shares a responsibility for the lost funds on ACA’s side.

Thus, we see that Goldman’s behavior in the Paulson & ACA deal indeed can be labeled as fraud. As I outlined above, the behavior of Goldman’s employees clearly checks all three boxes of fraudulent behavior. Goldman intentionally withheld information from ACA in order to create a market transaction which would be beneficial to Goldman and Paulson. ACA on the other hand, ultimately have to report a financial loss of $840 million.

Sources:

1. Rotemberg, Julio. “Subprime Meltdown: American Housing and Global Financial Turmoil.” *Harvard Business School*, 6 May 2006, pp. 1–13.
2. Schrieber, Andrew. 2012, pp. 1–14, *The Investment Bank Job*.