

U.S. NEWS & WORLD REPORT

April 16, 2010

Can the SEC Beat Goldman Sachs?

By Rob Silverblatt

News that the Securities and Exchange Commission filed a civil suit against Goldman Sachs has sent the investment bank's stocks reeling. But are investors overreacting?

To be sure, the case is bad news for Goldman, which has come under fire recently for its handling of mortgage-backed securities during the downturn. Even so, experts agree that the SEC will have to navigate a legal minefield in order to win a verdict against Goldman.

"I do think it's winnable, but it's a very complex case," says Jacob Zamansky, the founder of the New York-based financials and securities law firm Zamansky & Associates. "The SEC is going to have to do its homework."

At issue are the mortgage-backed securities that Goldman packaged and sold to its clients. Goldman then bet against those very same securities, turning a hefty profit when the housing market tanked.

According to the SEC, Goldman allowed hedge fund manager John Paulson to hand-pick risky mortgage bonds, which the investment bank would then package and sell to investors who believed that the securities would appreciate in value.

But Goldman, along with Paulson and other select clients, believed that the bonds were doomed to fail, the SEC alleges, meaning that they essentially made money off of the losses of Goldman investors who weren't privy to the true purpose of the mortgage bundles. The SEC says Goldman defrauded these investors by not telling them about Paulson's relationship to the mortgages.

"Goldman wrongly permitted a client that was betting against the mortgage market to heavily influence which mortgage securities to include in an investment portfolio, while telling other investors that the securities were selected by an independent, objective third party," SEC Enforcement Director Robert Khuzami said in a statement.

Shortly afterward, Goldman retaliated against the charges in a statement of its own. "The SEC's charges are completely unfounded in law and fact and we will vigorously contest them and defend the firm and its reputation," Goldman said.

Still, Brian Smiley, a securities lawyer with the Atlanta-based firm Smiley, Bishop & Porter, says that purchasers of the bonds had a right to know about their origins. "If you go to a brokerage firm and

you take advice from the brokerage firm ... you have every right and reason to believe that it is their best and most disinterested advice. And if they're betting the other way with their own money, it's a pretty good indication that it wasn't," he says.

The stakes, of course, are high for Goldman, but this case is perhaps an equally important test for the beleaguered SEC, which has been slammed for allegedly falling asleep at the switch over the past several years.

"This is a very major case," says Zamansky. "I think it will be very significant, and it will also be a test for the SEC, which has been criticized for missing Madoff and going easy on Bank of America. [This will show] whether they have the fortitude to bring a fraud case against Goldman Sachs and finish it."

The implosion of the housing market has long been fodder for lawsuits, with investors claiming that they had been misled about how risky the investments were.

"The problem with those lawsuits is you'd have to show that the defendant knew

something more about the riskiness of them than anyone else did," says Adam Pritchard, a securities law professor at the University of Michigan Law School. As a result, investors have been largely fighting an uphill battle. "[Mortgages] blew up in everyone's face," says Pritchard. "The courts have said that this is fraud by hindsight, that now we know that they were very risky, but we didn't at the time."

But this case is different. **"The heart of this case is the conflict of interest," says Zamansky.** As a result, it's more about whether Goldman should have notified investors than it is about how risky the mortgages were. "It really doesn't have anything to do with the riskiness," says Pritchard. As a result, he says that the SEC could have an easier time winning it.

Still, establishing the conflict is easier said than done, and it remains to be seen how thoroughly the SEC can develop the connection between Paulson and Goldman. **"That link is going to be crucial," says Zamansky.**