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Goldman Sachs Clients-First Pledge Undercut by SEC (Update1)

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By Christine Harper

April 17 (Bloomberg) -- **Goldman Sachs Group Inc.**'s efforts to burnish its reputation just got a lot tougher.

Chairman and Chief Executive Officer **Lloyd Blankfein**, 55, spent the last year defending the firm against criticism from politicians and pundits, who decried Goldman Sachs's profit in the aftermath of the financial crisis and its sale of mortgage securities that went sour. Now the U.S. Securities and Exchange Commission is charging the company with fraud.

On Goldman Sachs's list of business principles, "clients' interests always come first" ranks highest. The SEC paints a different picture. The firm failed to tell investors when selling them a so-called collateralized debt obligation tied to mortgages that the package had been designed to fail by hedge fund Paulson & Co., which profited from the losses, the agency alleged. Goldman Sachs said it will contest the case, calling it "completely unfounded in law and fact." Shareholders weren't comforted: The stock plunged the most in more than a year.

"The risk is long-term reputational," said **Benjamin Wallace**, an analyst at Grimes & Co. in Westborough, Massachusetts, which manages $900 million and doesn't own Goldman Sachs stock. "People are going to be more inclined to look at Goldman Sachs and think, 'Who's on the other side of this trade?'"

Goldman Sachs sank 13 percent to $160.70 in New York Stock Exchange composite trading, the biggest one-day percentage decline since January 2009. The cost to buy insurance against a default on Goldman Sachs debt jumped 35 basis points, or 0.35 percentage point, to 130.5 basis points in the biggest increase in a year.

'Worst-Case Liability'

The suit's financial cost to Goldman Sachs, whose $13.4 billion profit last year set a record for a Wall Street securities firm, is likely to be manageable and a settlement is unlikely before 2011, according to **Brad Hintz**, an analyst at Sanford C. Bernstein & Co. in New York.

The "worst-case liability" if the SEC case succeeds would be $706.5 million hit to net income, or $1.20 in earnings per share, Hintz estimated in a note to investors yesterday. Follow- on claims from investors will "face a challenging hurdle" because the securities were sold in a private placement only available to sophisticated investors, Hintz said.

Some analysts said that a more important problem is that the SEC's focus on Goldman Sachs shows the firm is under a harsher political and regulatory spotlight than competitors.

Goldman Agenda

Although the SEC warned Goldman Sachs last year that it was investigating this transaction and might eventually file charges, the regulator didn't notify the firm that it planned to file the suit yesterday, according to a person close to the firm. People within the company interpreted it as a sign the SEC has become unusually adversarial, the person said.

"At the moment, it looks as if the SEC is pursuing an agenda aimed specifically at Goldman," **Chris Kotowski**, a managing director at Oppenheimer & Co. in New York, wrote in a note to clients. "We believe that GS is probably vulnerable to more charges and outsized fines, and we are for now downgrading the stock to perform from outperform."

Reactions to the SEC suit on Capitol Hill underscored Goldman Sachs's role as a lightning rod for political outrage. Senate Banking Committee Chairman **Christopher Dodd**, a Connecticut Democrat, said the case demonstrates the need for Wall Street reform. House Minority Leader **John Boehner**, an Ohio Republican, said the SEC suit provides further reason to oppose the Democrats' legislation.

Blankfein's Prospects

"These are very serious charges against a key supporter of President Obama's bill to create a permanent Wall Street bailout fund," Boehner said in a statement after the SEC case was announced. The bill "gives Goldman Sachs and other big Wall Street banks a perpetual, taxpayer-funded safety net by designating them 'too big to fail.'"

Corporate customers and institutional investors will continue to rely on Goldman Sachs and the company's business is likely to survive and thrive, said **Richard Bove**, an analyst at Rochdale Securities in Lutz, Florida. Still, he said Blankfein and Chief Financial Officer **David Viniar**, 54, may need to step down "for the devastating decline in this company's persona."

"These men are brilliant and capable but this situation is now out of hand," Bove, who recommends buying Goldman Sachs shares, said in a note to investors. "There is a deep bench at Goldman and these executives, despite their capabilities, can be replaced."

Lucas van Praag, a spokesman for Goldman Sachs in New York, declined to comment.

Questions for Viniar

Blankfein, who has worked at Goldman Sachs since joining its commodities division, J. Aron & Co., in 1982, succeeded **Henry Paulson** as chairman and CEO in 2006 when Paulson left to become Treasury Secretary in the Bush administration. The next year, Goldman Sachs set a Wall Street profit record helped by bearish bets on subprime mortgage investments. Blankfein received a $67.9 million bonus, an all-time high for the CEO of a securities firm.

Viniar, the firm's chief financial officer since 1999, is one of the most public faces of Goldman Sachs. He fields questions from analysts and investors on the firm's results every quarter. He's slated to face their questions again next week, when Goldman reports first-quarter figures.

In their annual letter to shareholders last week, Blankfein and Goldman Sachs President **Gary Cohn** said most of the firm's business is aimed at serving sophisticated clients capable of making their own decisions.

Tourre and Paulson

"The investors who transacted with Goldman Sachs in CDOs in 2007, as in prior years, were primarily large, global financial institutions, insurance companies and hedge funds," the letter said. The firm "did not know whether the value of the instruments we sold would increase or decrease."

That contrasts with the SEC's allegations. The suit says **Fabrice Tourre**, a 31-year-old vice president at Goldman Sachs, knew that the Paulson hedge fund firm had helped select the assets backing a collateralized debt obligation called Abacus 2007-AC1, even as Paulson planned to bet on it failing. The

SEC says Tourre misled a collateral manager, ACA Management LLC, and an investor, **IKB Deutsche Industriebank AG**, about Paulson's role.

"Marketing materials for Abacus 2007-AC1 were false and misleading because they represented that ACA selected the reference portfolio while omitting any mention that Paulson, a party with economic interests adverse to CDO investors, played a significant role in the selection of the reference portfolio," the SEC argues.

'Cynical, Savage'

Tourre, reached yesterday at his office in London, where he is now an executive director, declined to comment. **Annette Littmann**, a spokeswoman for Duesseldorf-based IKB, said "IKB is aware of the SEC's lawsuit and supported the SEC upon request."

The SEC's accusations may fuel critics' claims that the firm put its own interests ahead of clients' and profited from practices that led to the financial crisis.

"Goldman Sachs said they sold only to sophisticated investors, but the damage they did was so pervasive that unsophisticated investors got snared in their web too," said **Janet Tavakoli**, president of Tavakoli Structured Finance Inc. in Chicago.

Christopher Whalen, a bank analyst at Torrance, California- based Institutional Risk Analytics, told investors yesterday that "this litigation exposes the cynical, savage culture of Wall Street that allows a dealer to commit fraud on one customer to benefit another."

'Out of Character'

William Cohan, a former investment banker who is writing a book about Goldman Sachs, said the accusations are surprising because the firm generally is diligent when it comes to legal disclosures. That the suit names none of Tourre's superiors may signal that senior management can escape blame, he said.

"It just strikes me as being entirely out of the firm's character, as much as people like to hate them, because they are much too careful on the whole legal front and disclosure front," Cohan said in an interview.

The SEC has "only named a VP, it's not going up the chain here at the moment, so I think that's an important distinction to make," Cohan said. "There are bad apples in any firm."

In a statement, Goldman Sachs made what it called "four critical points" in its defense against the SEC's accusations. The first was that Goldman Sachs itself lost more than $90 million because it had an investment in the deal that overwhelmed the $15 million it made in fees.

Paulson Statement

The firm said it provided "extensive disclosure" to IKB and ACA about the risk of the underlying mortgage securities. It said that ACA, whose $951 million investment made it the most exposed to risk, selected the portfolio. And the firm disputed the SEC's accusation that Goldman Sachs told ACA that Paulson & Co. was going to be an investor in the CDO.

Paulson's firm, which hasn't been charged with any wrongdoing, said in a statement that "ACA as collateral manager had sole authority over the selection of all collateral in the CDO" and that Paulson didn't "sponsor or initiate" Goldman's Abacus program. The fund says that while it did purchase credit protection from Goldman Sachs on some Abacus securities, it wasn't involved in the marketing.

Goldman Sachs's loyalty to clients has been questioned before. E-mails released by congressional investigators earlier this week show that Washington Mutual Inc.'s former CEO, **Kerry Killinger**, didn't want to hire a Goldman Sachs banker in 2007 to help with the bank's credit problems before it collapsed.

Best Models, Brightest Minds

"They are smart, but this is swimming with sharks," Killinger wrote in an Oct. 12, 2007, e-mail to a deputy. "They were shorting mortgages big time while they were giving CfC advice," he added, referring to Countrywide Financial Corp., the home lender that ran short of cash the same year.

One investor said that perception hasn't prevented Goldman Sachs from winning client business before and he doesn't think it will now.

"There's that cachet that they've had that not only are they the smartest guys in the room, but they might be playing you," said **Peter Sorrentino**, a senior portfolio manager at Huntington Asset Advisors in Cincinnati, which manages about $13 billion, including Goldman Sachs stock. Still, "the people at Goldman really do have the best models, they do have the brightest minds" and they will keep winning clients.

He said the market reaction to the SEC's suit probably reflects fear that wider criminal charges could follow, and represents a good opportunity to buy the stock.

"I'm just happy that it wasn't the FBI kicking in the door," Sorrentino said.

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