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Tracking the Fallout on Goldman

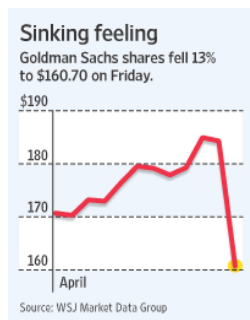
Wall Street foresees an 'incredible battle'; some see government's case as strong, while others say stock fell too far

By [AARON LUCCHETTI](#) And [RANDALL SMITH](#)

Friday, news of U.S. regulators' fraud lawsuit against Goldman Sachs Group Inc. dominated trading floors and financial channels.

Saturday, it moved to little-league sidelines, birthday parties and other weekend venues of adult conversation.

"It's the flavor of the day," said Gustavo Dolfino, senior managing director at executive recruiting firm Accretive Solutions, on his way to a dinner meeting in London. The Goldman case, he said, was the No. 1 topic at nearly every meeting he had there this weekend.



The Securities and Exchange Commission on Friday filed civil charges against Goldman, claiming it deceived clients by selling them mortgage securities designed by a hedge-fund firm run by John Paulson, without revealing his role in structuring the deals. Mr. Paulson profited from betting on the housing market's collapse. Goldman has denied the charges. Mr. Paulson and his company, Paulson & Co., aren't charged.

Some welcomed the government's move or thought it had legs.

"We're starting to peel back a layer of the onion that we hadn't gotten to yet," said Christopher Whalen, managing director of Institutional Risk Analytics, a research and risk-management firm. After reviewing the case, Mr. Whalen said it appears the "SEC has been very cautious."

Catherine Banat, a former Goldman employee in treasury and securities services who now specializes in compliance issues, said she has felt "shock and disappointment" at the charges. "We all hold Goldman to a higher standard," she explained.

On the other hand, Ms. Banat said, the case "reassures investors that the SEC is investigating and trying to be more vigilant. If it has substance, it would be a big win for the SEC."

The head of a boutique advisory firm, Peter J. Solomon, said "this allegation, even if unproven, strikes at the heart of the securities industry because participants have to believe they are dealing with counterparties in good faith."

Others were sympathetic to the investment bank's position, namely that it didn't need to disclose Paulson & Co.'s role in shaping the securities and it didn't mislead others in the process as to the hedge-fund firm's bearish position.

"I kind of rushed to judgment," upon first seeing the charges, said David Trone of Macquarie Securities, who follows banks and broker-dealers. The "claim obviously makes the target look pretty guilty."

But after Goldman gave a detailed statement Friday afternoon, Mr. Trone said, "it was pretty convincing as well. It seems like there are two sides of every story.... It's going to be an incredible battle."

In Greenwich, Conn., Gary Cunningham, chief executive of boutique investment bank Execution Noble LLC, stared at his computer screen Saturday while glancing at an English Premier League soccer match on television. He exchanged emails with colleagues about what the Goldman bombshell meant.

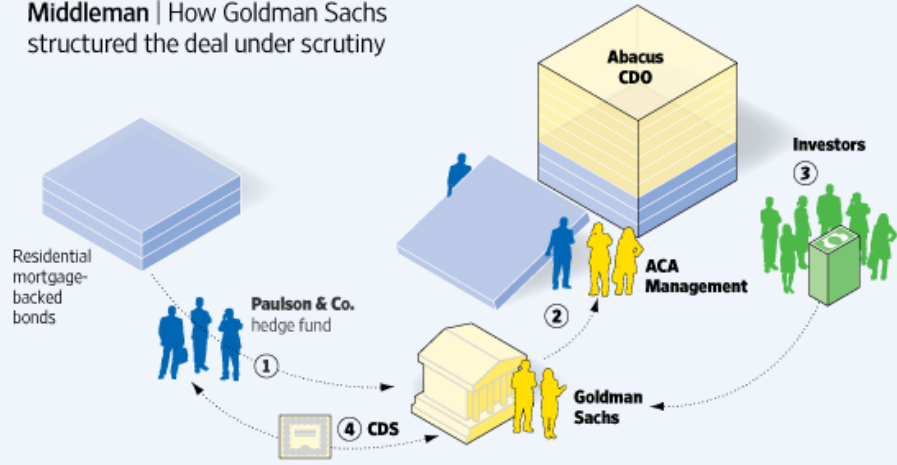
His view: investors overreacted to the news. Goldman's stock fell nearly 13% Friday. "To take \$13 billion off the market capitalization of Goldman Sachs is overdone," said Mr. Cunningham, who questions whether the case will succeed. Traders like to exit their positions before a weekend anyway, he figured.

The case signals a turn toward an even more difficult environment for Wall Street, particularly on the lightly regulated area of derivatives trading, some said.

The regulators "all have something to prove," said Institutional Risk Analytics' Mr. Whalen. "In the past they leaned in the industry's direction. Now they are leaning the other way."

"People are thinking about how much of the vigorish will be taken out of the over-the-counter" part of Wall Street trading, he said.

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1. Beginning in late 2006, the Paulson firm identifies 123 mortgage-backed securities that it expects to decline in value. The firm approaches Goldman Sachs about creating an investment vehicle known as a CDO that will track the value of these securities.

2. Goldman asks an 'independent third-party', ACA Management, to help design the security, known as Abacus. ACA does so with heavy involvement from Paulson. ACA is not aware that Paulson intends to bet against the portfolio, according to the SEC complaint.

3. A number of investors—including German bank IKB—buy slices of Abacus, expecting consistent returns from home mortgages.

4. Paulson buys credit-default swaps from Goldman, wagering that Abacus would decline in value. By January 2008, 99% of the portfolio had been downgraded. Paulson's bet paid off, netting about \$1 billion in profit. Goldman collects fees from all sides in the trade, but says it ended up losing \$90 million on its investment.

Source: SEC complaint

Andrew Garcia Phillips/The Wall Street Journal

Write to Aaron Lucchetti at aaron.lucchetti@wsj.com and Randall Smith at randall.smith@wsj.com