



Material for a fraud ?

... a selective reading of a broad range of Abacus 2007-AC1 related material that may or may not enter consideration in the S.E.C. case - part I

7th May 2010, by Médéric L. Pascal



Goldman Sachs' headquarters

ON THE 16TH OF APRIL, THE S.E.C. FILED A COMPLAINT AGAINST GOLDMAN SACHS & CO. AND ONE OF ITS EMPLOYEE ALLEGING FRAUD ON BOTH INTENTIONAL AND NEGLIGENT BASIS. GOLDMAN SACHS' DEFENCE APPEARS TO BE ESSENTIALLY TWO-FOLD: A) INVESTORS IN ABACUS WERE SOPHISTICATED AND INSTITUTIONAL ENTITIES CAPABLE OF ASSESSING THE RISKS INVOLVED IN THE TRANSACTION B) COMMON MARKET PRACTICES WERE OBSERVED BY GOLDMAN SACHS IN THE MATTER OF ELEMENTS' DISCLOSURE. IN CONSEQUENCE G. S.' ATTORNEYS APPEAR IN THE WELLS SUBMISSION AND ITS SUPPLEMENT TO DENY MATERIALITY TO THE ELEMENTS RAISED BY THE S.E.C. AND THUS REJECT THE FRAUD CASE AS A WHOLE. CAN A QUANTUM OF MATTER BE FOUND IN THE RELATIVISTIC UNIVERSE OF SYNTHETIC CDO PRACTICES?

“Purchasing the Notes involves certain risks. Prospective investors should carefully consider the following factors, as well as the risk factors included in the final Offering Circular, prior to purchasing the Notes.”

“Goldman Sachs *may have potential conflicts of interest* due to present or future relationships between Goldman Sachs and any Collateral, the issuer thereof, any Reference Entity or any obligation of any Reference Entity.”

“Goldman Sachs may, by virtue of its status as an underwriter, advisor or otherwise, possess or have access to non-publicly available information relating to the Reference Obligations, the Reference Entities and/or other obligations of the Reference Entities and has not undertaken, and does not intend, to disclose, such status or non-public information in connection with the Transaction. Accordingly, this presentation may not contain all information that would be material to the evaluation of the merits and risks of purchasing the Notes.”

“Goldman Sachs is currently and may be from time to time in the future an active participant on both sides of the market and have long or short positions in, or buy and sell, securities, commodities, futures, options or other derivatives identical or related to those mentioned herein.”

“Goldman Sachs & Co. will act as the initial purchaser for all classes of Notes, and affiliates of Goldman Sachs & Co. will act as the Protection Buyer, the Basis Swap Counterparty, the Collateral Put Provider and the Collateral Disposal Agent.”

*Abacus 2007-AC1 Flipbook*¹, pp. 6 & 8 (pdf pp. 7 & 9)

(Emphasis added)

Purchasing the notes involves certain risk... Sorry, certain risk-*s*. Well it is precisely the issue between the parties: did purchasing involve *certain risk* for the investor, albeit sophisticated institutional ones or did it not? While the S.E.C. claims, without claiming it too loud, it did, it did intentionally so and in fact was designed in order to do so, the contending party says: No Sir, not at all, it did not! Ludicrous, baseless and insulting a claim to the reputation of our noble client, this *procès d'intention* conducted by a mad regulator!

Certainly if it did, it is quite unlikely to be enough for the defending party to go hiding behind the dubious shield of the opening disclaimer. Worth noticing, *with whom* the possible conflicts of interest may occur is not specified. Due to the complex nature of the transaction, the answer may not be as obvious as it seems and at all events, it is far less commercially unfriendly to state: Goldman Sachs may have potential conflicts of interest due to present or future relationships between Goldman Sachs and any Collateral, the issuer thereof, any Reference Entity or any obligation of any Reference Entity than to simply state: Goldman Sachs may have conflicts of interest with the investors in this deal. Of course you cannot build up a successful brand without being clever to a *certain* extent in matters of commercial presentation...

A funny peculiarity of this notice of possible conflicts of interest is that it should appear in the *risk factors* section of the document. As if the redactor(s) meant to imply that it was a risk *per se* for the prospected investor(s) to have Goldman (possibly) engaging in an adverse position. As if Goldman could never possibly be wrong..

The next issue seems to break all false pretence of dubiousness in determining whether or not there is something rotten in the kingdom of synthetic CDO business:

“Goldman Sachs may, by virtue of its status as an underwriter, advisor or otherwise, possess or have access to non-publicly available information relating to the Reference Obligations, the Reference Entities and/or other obligations of the Reference Entities and has not undertaken, and does not intend, to disclose, such status or non-public information in connection with the Transaction.”

“Goldman Sachs is currently and may be from time to time in the future an active participant on both sides of the market and have long or short positions in, or buy and sell, securities, commodities, futures, options or other derivatives identical or related to those mentioned herein.”

Here it might be worthwhile to indicate to the less abacus-informed reader that the S.E.C. claim for fraud revolves about the active role in the selection process of the reference obligation portfolio of a client of Goldman's (towards whom Goldman serves as counsel or adviser) whose explicit and undisputed interest it was to see lesser quality mortgage securities to be selected in the reference portfolio.

According to the above-cited provision Goldman Sachs & Co. admits it may have privileged information about elements of the deal – such as, say, the reference portfolio; Furthermore they state their intention *not to* disclose such elements in case of their actual occurrence.

Now in the next paragraph, it is stated that, although possibly having this privileged access to non-public information they intend to: “be from time to time in the future an active participant on both sides of the market and have long or short positions in, or buy and sell, securities, commodities, futures, options or other derivatives identical or related to those mentioned herein”

Leaving aside the question whether or not they actually had such privileged information in the course of the transaction for the time being, is it not yet already quite disturbing *in principles* that they should express their relative ease in undertaking what greatly resembles, in another context, insider trading? Transpose what is stated in these paragraphs in an equity environment, replace the words: *obligations* and *reference portfolio* by shares (or stocks) and pool of stocks and decide for yourself: would it be fair to the investors, would it be legal?

Now the last paragraph in our opening citation states in though probably accurate yet very cryptic manner how Goldman Sachs stands initially in this deal:

“Goldman Sachs & Co. will act as the initial purchaser for all classes of Notes, and affiliates of Goldman Sachs & Co. will act as the Protection Buyer, the Basis Swap Counterparty, the Collateral Put Provider and the Collateral Disposal Agent.”

Perhaps at core of the dispute between the S.E.C and Goldman, the role of the latter as initial “Protection Buyer.” Is it not remarkable that *not once* in the whole Risk Factors section of the *Flipbook* the words Credit Default Swaps or the acronym CDS appear? Not once... In all likelihood Goldman would hedge this interrogation with its accustomed remarks on the alleged “sophistication” of the institutional investors the product is intended to. Yet, not a single word on the CDS mechanisms in the risk factors section when the CDO is all about CDS risks given its synthetic nature; and naturally no definition is provided at this stage of the very notion of Protection Buyer either. “What is a protection buyer?” may the less sophisticated reader here wonder. Well, it shall be given him the occasion to get acquainted with the notion (and the CDS scheme) in later parts of the present discussion.



I am a material frog in a material pool...

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Notes

1. The 65 pages' long Abacus 2007-AC1 commercial brochure dated 26th February 2007 is commonly referred to as 2007-AC1 *Flipbook* or simply in context the *Flipbook* and shall be thus designated in the rest of the document