Professors Discuss Goldman Suit

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The Securities and Exchange Commission's recent suit against Goldman Sachs raises new questions about securities regulation from both legal and ethical standpoints, according to professors from Harvard Law School and Harvard Business School.

The SEC alleged on Friday that Goldman misrepresented to investors, including financial institutions IKB and ACA Capital, the involvement of a major hedge fund in assembling a portfolio of mortgage-backed securities that the fund later bet against.

Goldman has denied the allegations and stated in a press release that it will "vigorously contest" the SEC's charges.

According to Law School Professor Jesse M. Fried '86, the question at the heart of the case is whether or not hedge fund manager John Paulson's involvement in structuring the portfolio in 2006 was "material"—that is, significant to a buyer's decision to purchase the securities.

Paulson has become well-known in financial circles for his negative outlook on the real estate market at the peak of the housing bubble and earned billions in 2007 in part by betting against mortgage-backed securities. IKB and ACA suffered significant losses on the portfolio.

The SEC would also need to prove that Goldman had a duty to disclose Paulson's role, and that buyers incurred damages as a result of his involvement.

Business School professors said that the case raises important ethical issues, but that the legal grounding of the SEC's suit is unclear.

Law School Professor Allen Ferrell noted that Paulson's actions likely did not constitute wrongdoing, if the hedge fund was independently speculating on future market movements—which is not fraudulent behavior on its own.

But Business School Professor Michael D. Kimbrough questioned whether Paulson's involvement could be considered proper business practice.

Kimbrough suggested that some people doubt whether the buyers' decision to enter the transaction would have been impacted by the knowledge of Paulson's strategy to short the securities, since Paulson had not yet gained recognition for his foresight on falling housing prices.

Additionally, Kimbrough said that under current statutes, financial institutions such as IKB and ACA are expected to research their own investments.

Business School professors said that greater transparency in derivative transactions could help prevent similar situations in the future.

Kimbrough said that current securities regulations are focused on protecting individuals from investment fraud rather than protecting financial institutions.

Bills regulating derivative exchanges are currently under review in the House and Senate, but Business School professor David A. Moss stressed that these new regulations, had they been in place at the time, may not have prevented the alleged fraud.

“Fraud is not 100 percent preventable, even with good regulation,” Moss warned.

Rebuidling and Preserving Reputation

The SEC may have a stake in regaining its credibility as a regulatory body, according to Law School professors.

“They are interested in trying to rehabilitate themselves,” said Fried, noting that the organization has suffered criticism for its handling of the Madoff fraud and the Bank of America litigations. “They have to show that they can shoot straight and that they have a role to play.”

Business School Professor Robin M. Greenwood said that Goldman is a “convenient target” for people who are looking for a scapegoat in the wake of the crisis.

For Goldman, reputation is also at stake, as well as the possibility of further legal actions on other transactions, Ferrell said. According to Law School Professor Howell E. Jackson, the SEC has a plausible case and Goldman will not be confident enough to go to trial. Ferrell, Jackson, and Fried said they believe that Goldman will settle.

But they acknowledged that much factual evidence has yet to be revealed.

“At the end of the day it will depend on the economic and legal merits of the case and rise and fall on that,” Ferrell said.

This article has been revised to reflect the following correction:

CORRECTION: April 21, 2010

An earlier version of the Apr. 21 news article "Professors Discuss Goldman Suit" incorrectly attributed to Law School Professor Allen Ferrell the statement that hedge fund manager John Paulson's speculation on future market movements likely did not constitute wrongdoing. In fact, Ferrell said that if Paulson had only made independent speculations, then his actions would not constitute wrongdoing.