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S.E.C. Accuses Goldman of Fraud in Housing Deal

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Goldman Sachs, the Wall Street powerhouse, was accused of securities fraud in a civil lawsuit filed Friday by the Securities and Exchange Commission, which claims the bank created and sold a mortgage investment that was secretly intended to fail.

The move was the first time that regulators had taken action against a Wall Street deal that helped investors capitalize on the collapse of the housing market.

The suit also named Fabrice Tourre, a vice president at Goldman who helped create and sell the investment.

In a statement, Goldman called the commission’s accusations “completely unfounded in law and fact” and said it would “vigorously contest them and defend the firm and its reputation.”

The focus of the S.E.C. case, an investment vehicle called Abacus 2007-AC1, was one of 25 such vehicles that Goldman created so the bank and some of its clients could bet against the housing market. Those deals, which were the subject of an article in The New York Times in December, initially protected Goldman from losses when the mortgage market disintegrated and later yielded profits for the bank.

As the Abacus portfolios in the S.E.C. case plunged in value, a prominent hedge fund manager made money from his bets against certain mortgage bonds, while investors lost more than $1 billion.

According to the complaint, Goldman created Abacus 2007-AC1 in February 2007 at the request of John A. Paulson, a prominent hedge fund manager who earned an estimated $3.7 billion in 2007 by correctly wagering that the housing bubble would burst. Mr. Paulson is not named in the suit.

Goldman told investors that the bonds would be chosen by an independent manager. In the case of Abacus 2007-AC1, however, Goldman let Mr. Paulson select mortgage bonds that he believed were most likely to lose value, according to the complaint.

Goldman then sold the package to investors like foreign banks, pension funds and insurance companies, which would profit only if the bonds gained value. The European banks IKB and ABN Amro and other investors lost more than $1 billion in the deal, the commission said.

“Goldman wrongly permitted a client that was betting against the mortgage market to heavily influence which mortgage securities to include in an investment portfolio,” Robert Khuzami, the director of the commission’s enforcement division, said in a written statement.

The lawsuit could be a sign of a revitalized Securities and Exchange Commission, which has been criticized for early missteps in assessing the causes of the financial crisis. The agency appears to be tracing the mortgage pipeline all the way from the companies like Countrywide Financial that originated home loans to the raucous trading floors that dominate Wall Street’s profit machine.

At a conference in New Orleans on Friday, Mr. Khuzami indicated that he was scrutinizing other deals involving mortgage securities. “We’re looking at a wide range of products,” he said at a news conference. “If we see securities with similar profiles, we’ll look at them closely.”

Shares of Goldman Sachs plunged more than 10 percent in just the first half-hour of trading after the suit was announced Friday morning. They closed down 13 percent, at $160.70, wiping away more than $10 billion of the company’s market value.

Investors sold other bank stocks, as well, as rumors swirled about which other firms might become embroiled in the commission’s investigation. Next to Goldman Sachs, Deutsche Bank’s American shares had the steepest decline, falling 7 percent.

Goldman issued a second statement after the market closed saying that the firm had lost money on the deal in the S.E.C. case and that it provided investors with extensive disclosure on the deal. The firm said the losses in the deal came from the overall collapse of the mortgage market, not from the way the deal was structured.

The accusations amount to a black eye for the once-untouchable Goldman Sachs, a money machine that is the epicenter of Wall Street power. For decades, its platinum reputation has attracted top investors and stock underwriting deals.

Several of its former chief executives have gone on to high public office, among them Henry M. Paulson Jr., the former Treasury secretary, and Jon Corzine, the former New Jersey governor.

(Henry Paulson and John Paulson are not related.)

In recent months, Goldman has been defiant in the face of criticism, repeatedly defending its actions in the mortgage market, including its own bets against it. In a letter published last week in Goldman's annual report, the bank rebutted criticism that it had created, and sold to its clients, mortgage-linked securities that it had little confidence in.

"We certainly did not know the future of the residential housing market in the first half of 2007 any more than we can predict the future of markets today," Goldman wrote. "We also did not know whether the value of the instruments we sold would increase or decrease."

The letter continued: "Although Goldman Sachs held various positions in residential mortgage-related products in 2007, our short positions were not a 'bet against our clients.' " Instead, the trades were used to hedge other trading positions, the bank said.

Goldman was one of many Wall Street firms that created complex mortgage securities — known as synthetic collateralized debt obligations — as the housing wave was cresting. At the time, traders like Mr. Paulson, as well as those within Goldman, were looking for ways to bet against the overheated market.

For months, S.E.C. officials have been examining mortgage bundles like Abacus that were created across Wall Street. The commission has been interviewing people who structured Goldman mortgage deals about Abacus and similar instruments. The commission advised Goldman that it was likely to face a civil suit in the matter, sending the bank what is known as a Wells notice several months ago.

The S.E.C. action is a civil complaint, but it could be referred to criminal prosecutors who would have to prove that individuals intended to defraud investors.

The S.E.C. focused on only one Abacus deal in its complaint, but Mr. Khuzami said in a conference call on Friday that the commission continued to look at the rest. All told, $10.9 billion of Abacus investments were sold.

Mr. Tourre, the Goldman vice president named in the lawsuit, was one of the firm's top workers running the Abacus deals, selling the investment to investors across Europe. Mr. Tourre was raised in France and moved to the United States in 2000 to earn his master's degree in operations at Stanford. The next year, he began working at Goldman, according to his profile on the LinkedIn social network.

He rose to prominence working on the Abacus deals under a trader named Jonathan M. Egol. Mr. Egol, who is now a managing director at Goldman, is not named in the S.E.C. suit.

Goldman structured the Abacus portfolios with a sharp eye on the credit ratings assigned to the mortgage bonds contained in them, the S.E.C. said. In the Abacus deal cited in the S.E.C. complaint, Mr. Paulson pinpointed those mortgage bonds that he believed carried higher ratings than the underlying loans deserved.

Goldman placed insurance on those bonds — called credit-default swaps — inside Abacus, allowing Mr. Paulson to bet against the bonds while clients on the other side of the trade wagered that they would make money.

But when Goldman sold shares in Abacus to investors, the bank and Mr. Tourre disclosed only the ratings of those bonds and did not disclose that Mr. Paulson was on the other side, betting those ratings were wrong.

Mr. Tourre at one point complained to an investor who was buying into Abacus that he was having trouble persuading Moody's to give the deal the rating he desired, according to the investor's notes, which were provided to The Times by a colleague who asked for anonymity.

In seven of Goldman's Abacus deals, the bank went to the American International Group for insurance on the bonds. Those deals have led to billions of dollars in losses at A.I.G., which received a $180 billion taxpayer rescue. The Abacus deal in the S.E.C. complaint was not one of them.

That deal was managed by ACA Management, a part of ACA Capital Holdings, which changed its name in 2008 to Manifold Capital.

Goldman told investors the mortgage bond portfolio would be "selected by ACA Management," according to the deal's marketing document, which was given to The Times by an Abacus investor. That document says Goldman may have long or short positions in the bonds. It does not mention Mr. Paulson.

ACA was not named in the suit. That firm was led to believe that Mr. Paulson was positive on mortgages, not negative, and so it did not see a problem with his involvement, the S.E.C. said. Mr. Tourre was aware of ACA's misconception, the commission said.

In February 2007, Mr. Tourre met with both ACA and Mr. Paulson, and he sent an e-mail message to a Goldman colleague acknowledging the awkwardness of the situation. "This is surreal," Mr. Tourre wrote.

Nine days later, a Goldman colleague wrote Mr. Tourre and said, "the C.D.O. biz is dead. We don't have a lot of time left."

The Abacus deals deteriorated rapidly when the housing market hit trouble. For instance, in the Abacus deal in the S.E.C. complaint, 83 percent of the mortgage bonds underlying it were downgraded by rating agencies just six months later, and 99 percent had been downgraded by early 2008, according to the S.E.C.

It takes time for such mortgage investments to pay out for investors who make bets against them. Each deal is structured differently, but generally, the bonds underlying the investment must deteriorate to a certain point before those who bet against the bonds get paid. By the end of 2007, Mr. Paulson’s credit hedge fund was up 590 percent.

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