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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@portfoliomedia.com

Goldman Sachs And The Wells Process

Law360, New York (May 24, 2010) -- The objective of the U.S. Securities and Exchange Commission's Wells process is to "place before the Commission prior to the authorization of an enforcement proceeding the contentions of both its staff and the adverse party concerning the facts and circumstances which form the basis for the staff recommendation."^[1]

Although the recipient of a Wells notice has access to the information and testimony the recipient provides, it is within the discretion of the commission's staff to provide, or deny, the recipient of a Wells notice with access to other testimony and information in the investigative record.^[2]

The commission's widely publicized enforcement action charging Goldman Sachs & Co. and Fabrice Tourre with fraud appears to highlight the importance of providing recipients of Wells notices with access to the investigative record.

The SEC allegations relate to the structuring and marketing of a synthetic collateralized debt obligation ("CDO"), ABACUS 2007-AC1. According to the commission's complaint, the marketing materials for ABACUS 2007-AC1 — including the term sheet, flip book and offering memorandum for the CDO — all represented that the reference portfolio of residential mortgage backed securities ("RMBS") underlying the CDO was selected by ACA Management LLC ("ACA"), a third party with expertise in analyzing credit risk in RMBS.

The commission alleged that Goldman Sachs failed to disclose that, Paulson & Co. Inc., a hedge fund, with economic interests directly adverse to investors in the ABACUS 2007-AC1 CDO played a significant role in the reference portfolio selection process. The complaint also alleges that after participating in the selection of the reference portfolio, Paulson effectively shorted the RMBS portfolio it helped select by entering into credit default swaps ("CDS") with Goldman Sachs to buy protection on certain layers of the ABACUS 2007-AC1 capital structure. Given its financial short interest, Paulson had an economic incentive to choose RMBS that it expected to experience credit events in the near future.

The commission further alleged that a Goldman Sachs officer misled ACA into believing that Paulson invested approximately \$200 million in the equity of ABACUS 2007-AC1 (a long position) and, accordingly, that Paulson's interests in the portfolio selection process were aligned with ACA's when in reality Paulson's interests were sharply conflicting. According to the commission's complaint, Goldman Sachs did not disclose Paulson's adverse economic interest or its role in developing the portfolio, term sheet, flip book, offering memorandum or other marketing materials.

CNBC has reported that it has examined documents showing that Paolo Pellegrini, a former Paulson & Co. lieutenant testified that he told ACA that Paulson & Co. was "interested in taking a short position in Abacus."^[3]

This testimony would appear to undermine significantly the staff's contention that ACA was misled into thinking that Paulson & Co. planned to be a long investor in the synthetic CDO.

In its Wells submissions, Goldman Sachs addresses four e-mails that the staff apparently cited in support of its contention that Goldman Sachs intentionally or negligently led ACA to believe that Paulson & Co. would be an equity investor in the 2007-ACI transaction.[4] Goldman Sachs does not refer to the testimony of Paolo Pellegrini in either of its Wells submissions.

The SEC Enforcement Manual gives the staff discretion to give the recipient of a Wells call access to the investigative record. Recipients of Wells notices occasionally request to review portions of the staff's investigative file. On a case-by-case basis, it is within the staff's discretion to allow the recipient of the notice to review portions of the investigative file that are not privileged.[5] The manual gives the staff broad discretion and identifies three factors that the staff should consider in considering a request for access to portions of the staff's investigative file:

- whether access to portions of the file would be a productive way for both the staff and the recipient of the Wells notice to assess the strength of the evidence that forms the basis for the staff's recommendations;
- whether the prospective defendant or respondent failed to cooperate, invoked his Fifth Amendment rights, or otherwise refused to testify during the investigation; and
- the stage of the investigation with regard to other persons or witnesses, including whether certain witnesses have yet to provide testimony

Since the Goldman Sachs Wells responses do not address Pellegrini's testimony, it appears that the staff exercised its discretion to not provide Goldman Sachs with access to Pellegrini's testimony. The Wall Street Journal has reported that the commissioners were aware of Pellegrini's testimony and discussed its significance before authorizing the filing of the enforcement action against Goldman Sachs.[6]

Nevertheless, the Enforcement Division's apparent decision not to provide Goldman Sachs with access to Pellegrini's testimony denied Goldman Sachs the opportunity to incorporate and analyze this testimony in its Wells submission and therefore denied the commission the benefit of reading Goldman Sachs' view. Skillful advocacy can enhance the persuasive power of the evidence. Furthermore, given their differing perspectives, an advocate may recognize the exculpatory nature of a fact that a staff member reasonably fails to recognize.

In addition, decisions by the staff to provide only limited information in the Wells process arguably pose an obstacle to settlement negotiations. A recipient of a Wells Notice might hesitate to settle with the Staff on the basis of incomplete access to the record if they believe that the staff might possess highly significant exculpatory information of which the recipient is unaware.

The staff's practice of sometimes providing limited or no access to the investigative record also can result in inappropriate settlements. Although it is in the public interest for wrongdoers to settle with the SEC, it is not in the public interest for innocent individuals and companies to settle with the SEC merely because they are unaware of potentially exculpatory evidence in the Staff's investigative file.

If the SEC litigates a civil or administrative enforcement action, the defendant or respondent will be provided access to the entire nonprivileged investigative record. Thus, Goldman Sachs either has or shortly will obtain access to the staff's investigative record, including all of the documents produced to the SEC during the investigation and transcripts of all of the testimony provided to the staff during the investigation. The issue highlighted by the Goldman Sachs matter is the extent to which the staff should provide access to the investigative record during the Wells process.

The Wells process was implemented in recognition of the powerful impact of Commission allegations of wrongdoing. We believe that the division should revise the Enforcement Manual to set forth a presumption that recipients of Wells notices will be provided reasonable access to the investigative record absent compelling reasons to the contrary.

We recognize that time and resource constraints may not permit the full access to the investigative record afforded to defendants and respondents after the commencement of a formal proceeding. However, greater access would improve the process. Greater access to the investigative record will also promote the ability of the commission to obtain just and appropriate settlements. Accordingly, such a revision would significantly enhance the ability of the commission and the staff to enforce the federal securities laws effectively.

--By Kenneth B. Winer (pictured) and Richard G. Wallace, Foley & Lardner LLP

Ken Winer and Richard Wallace are both partners at Foley & Lardner LLP in the firm's Washington, D.C., office. They can be reached at kwiner@foley.com and rwallace@foley.com.

The authors represent numerous individuals and entities who have received Wells notices from the SEC Division of Enforcement and represent Goldman Sachs in matters unrelated to the enforcement action discussed in the article.

The views expressed in this article are those of the authors and do not necessarily reflect those of their firm, colleagues or clients, or Portfolio Media, publisher of Law360.

[1] Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations, Securities Act Release No. 5310 (Sept. 27, 1972).

[2] SEC Enforcement Manual at 30, available at www.sec.gov/divisions/enforce/enforcementmanual.pdf.

[3] J. Cox, "Testimony Could Undercut SEC Charge Against Goldman," (Apr. 21, 2010) available at www.cnbc.com/id/36685026.

[4] Submission on Behalf of Goldman Sachs & Co. at 30 available at online.wsj.com/public/resources/documents/GSWellsSubmission.pdf.

[5] SEC Enforcement Manual at 30, available at www.sec.gov/divisions/enforce/enforcementmanual.pdf.

[6] M. Langley, Kara Scannell, S. Pulliam, and S. Craig, "SEC Chief's Big Bet on Goldman," The Wall Street Journal, A1, 11 (May 15-16, 2010).