

The SEC v. Goldman Sachs: Reputation, Trust, and Fiduciary Duties in Investment Banking

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On April 16, 2010, the Securities and Exchange Commission (SEC) filed a civil complaint against Goldman Sachs in the U.S. District Court for the Southern District of New York. The complaint alleged that Goldman Sachs violated the anti-fraud provisions of the federal securities laws in connection with a 2007 synthetic collateralized debt obligation (CDO) transaction, ABACUS 2007-AC1 SPV (ABACUS). Goldman Sachs agreed to a \$550 million settlement with the SEC on July 15, 2010. We analyze the ABACUS transaction and the SEC's complaint against Goldman Sachs in the context of recent technological changes within the investment banking market. Investment banking was historically a relationship-based business, sustained by reputationally intermediated

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tacit contracts. Recent advances in information technology and financial economics have codified many formerly tacit elements of investment banking. As a result, some investment banking deals are now transacted at arm's length and rely more upon formal contracts; we argue that, for this type of deal, there is a stronger case for legal rules regulating the investment bank counterparty relationship. However, some deals continue to be arbitrated by tacit rules and norms and, for these deals, legal rules are less appropriate, because it is very hard for a third party to ascertain tacit understandings made in the context of a long-lived relationship. An attempt to introduce legal rules into reputationally intermediated relationships may even impair the counterparties' ability to arrive at informal arrangements, and so to trade. The supervision of deals like ABACUS should therefore reflect the extent to which they are transactional or relational; we argue that in neither case is there justification for the application of legal rules or the gap-filling standard of fiduciary duties.

*In a market system based on trust, reputation has a significant economic value. I am therefore distressed at how far we have let concern for reputation slip in recent years.*¹

I. INTRODUCTION

On April 16, 2010, the SEC filed a civil complaint against Goldman Sachs in the U.S. District Court for the Southern District of New York.² The complaint alleged that Goldman Sachs violated the anti-fraud provisions of the federal securities laws in connection with a 2007 synthetic collateralized debt obligation (CDO) transaction, ABACUS.³ The immediate capital market reaction was very negative: Goldman Sachs' share price closed down more than 13% on the day, reflecting a reduction in market valuation of about \$10 billion.⁴ This price reaction anticipated the hostile reception that the firm received in subsequent Congressional hearings, and, apparently, in the court of

1. Alan Greenspan, Address at the Markets and the Judiciary Conference, Sandra Day O'Connor Project, Georgetown University (Oct. 2, 2008). See also Peter S. Goodman, *Taking a Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 8, 2008, at A1 (discussing Greenspan's view on the market system, regulation of the financial markets, and the role of trust and reputation).

2. See Press Release, SEC, SEC Charges Goldman Sachs With Fraud in Structuring and Marketing of CDO Tied to Subprime Mortgages (Apr. 16, 2010), available at <http://www.sec.gov/news/press/2010/2010-59.htm>.

3. Complaint, SEC v. Goldman Sachs & Co., 790 F. Supp. 2d 147 (S.D.N.Y. 2011) (No. 10 Civ. 3229), 2010 WL 1508202 [hereinafter SEC Complaint]. Under the CDO transaction, the ABACUS special purpose vehicle (SPV) sold notes whose value was tied to the value of a portfolio of residential mortgage backed securities (RMBS). *Id.* ¶¶ 1–5. The transaction was “synthetic” in that the reference portfolio was not purchased by the SPV, and, hence, did not appear on the SPV's balance sheet. *Id.* ¶ 1. Instead, the SPV used the money it received for selling the notes to purchase a portfolio of high-grade securities. These securities were used to collateralize a credit default swap (CDS) under the terms of which the SPV received regular payments in exchange for indemnifying its counterparty against losses incurred on the reference portfolio. *Id.* These payments were used to enhance the return that accrued to investors in the SPV's notes, who bore the economic risk of default on the reference portfolio. See GOLDMAN SACHS, ABACUS 2007-AC1 (2007) [hereinafter ABACUS FLIPBOOK], available at <http://www.scribd.com/doc/30036962/Abacus-2007-Ac1-Flipbook-20070226> (explaining the CDO transaction). See Part II *infra* for a more detailed discussion of the transaction.

4. See Louise Story & Gretchen Morgenson, *S.E.C. Accuses Goldman Of Fraud in Housing Deal*, N.Y. TIMES, Apr. 17, 2010, at A1 (illustrating the immediate negative capital market reaction).

public opinion.⁵ It was also well in excess of the \$550 million settlement that Goldman Sachs agreed with the SEC on July 15, 2010.⁶

The SEC's complaint is likely to be a watershed event for the investment banking industry. We argue in this Article that, in turn, the complaint reflects far-reaching structural changes in investment banks. The changes predate the financial crisis, and they are likely to result in further significant upheavals in the banking industry. The political and regulatory response to this change will affect the path of future upheavals, and, hence, will have a profound impact upon the future evolution of the investment-banking sector. The \$10 billion capital market reaction to the SEC's complaint reflects this impact.

Goldman Sachs remained committed to the partnership form longer than any of its bulge-bracket investment banking counterparts and in the wake of going public sharply increased its trading revenue relative to its traditional investment banking business.⁷ Moreover, Goldman Sachs is widely regarded as one of the most reputable industry players.⁸ The ABACUS transaction was not particularly innovative, and its execution was not unusual.⁹ In singling Goldman Sachs out for criticism, the SEC is effectively criticizing received norms and ways of doing investment-banking business.¹⁰

5. Sewell Chan & Louise Story, *Goldman Pays \$550 Million to Settle Fraud Case*, N.Y. TIMES, July 15, 2010, at A1.

6. Goldman acknowledged that its marketing material for the ABACUS transaction "contained incomplete information," but did not admit to the SEC's charges. See Consent of Defendant Goldman, Sachs & Co., SEC v. Goldman Sachs & Co., 790 F. Supp. 2d 147 (S.D.N.Y. 2011) (No. 10-CV-3229), 2010 WL 2779309. Goldman's shares closed 4.4% higher on the settlement date; at this level, they were still 20% below their level before the SEC filed charges. See Francesco Guerrero et al., *Goldman Sachs settles with SEC*, FIN. TIMES, July 16, 2010, <http://www.ft.com/cms/s/0/4bd43894-904c-11df-ad26-00144feab49a.html#axzz11RlItS4d> (describing the settlement reached between Goldman and the SEC and reporting its impact on Goldman Sachs' share price).

7. Goldman Sachs' Investment Banking revenues were substantially larger in 1998 at \$3368 million than Trading and Principal Transactions revenues which were at \$2379 million. See The Goldman Sachs Grp., Inc., Registration Statement (Form S-1), at F-2 (Feb. 14, 2000), available at <http://www.sec.gov/Archives/edgar/data/886982/0000950123-00-001147.txt>. By 2007, the balance had tipped and Investment Bank Revenues were \$7555 million versus Principal Transaction Revenues of \$31,226 million. See The Goldman Sachs Grp., Inc., Annual Report (Form 10-K), at 3 (Nov. 30, 2007), available at <http://www.sec.gov/Archives/edgar/data/886982/000095012308000857/y46519e10vk.htm>.

8. See generally CHARLES D. ELLIS, THE PARTNERSHIP: THE MAKING OF GOLDMAN SACHS (2008).

9. The first ABACUS transaction (ABACUS 2004-1) "was developed in response to IKB's desire to invest in AAA, AA, and A rated CDO notes referencing a portfolio of high-grade asset-backed securities." See Submission on Behalf of Goldman, Sachs & Co. at 10, *In re Matter of ABACUS CDO*, SEC File No. HO-10911 (Sept. 10, 2009) [hereinafter Goldman Sachs Submission]. ABACUS-2007-AC1 SPV refers to the bankruptcy remote legal entity, or "special purpose vehicle," created for the sole purpose of the transaction in question. *Id.* at 11. IKB is a German Bank that invested in multiple previous ABACUS transactions and was the primary note holder in the 2007 deal. *Id.* at 5.

10. We recognize the political dimension in the SEC's complaint. The SEC was under tremendous pressure to show its relevancy to the government and public generally, and this may have spurred the SEC to bring this complaint. See, e.g., *Investigating and Prosecuting Financial Fraud after the Fraud Enforcement and Recovery Act: Hearing Before the Comm. on the Judiciary*, 111th Cong. (Sept. 22, 2010) (opening statement of Edward E. Kaufman, Chairman, Cong. Oversight Panel) ("I will say right now that I'm frustrated. I know that the Justice Department, the FBI, and the SEC have all been working incredibly hard, reviewing countless transactions, interviewing myriad witnesses, poring over literally millions of pages of documents. And yet we have seen very little in the way of senior officer or boardroom-level prosecutions of the people on Wall Street

The SEC's complaint highlights the legal and reputational nature of an investment bank's responsibilities to its counterparties. The SEC's complaint was premised on a legal violation but was notable because it implicated the trust relationship between an investment bank and its counterparties.¹¹ The SEC asserted a formal violation of the antifraud rules, but appeared to be applying the rule to enforce a trust-like relationship among Goldman Sachs and its counterparties analogous to a fiduciary duty-type relationship.¹² But the role of trust in investment banking has changed significantly in recent years. Differing perceptions of the changing nature of normative responsibilities may therefore lie at the heart of the dispute between Goldman Sachs and the SEC.

Trust is important in trade where the formal contracting environment is weak. A weak contracting environment may reflect ineffective or corrupt courts, or it may reflect technological barriers to recording information and proving it in court.¹³ For investment banks whose main stock-in-trade is information, the latter problem predominates. Notwithstanding its centrality to economic life in developed economies, data about the quality of a stock issue or about market conditions is typically impossible to contract upon. Parties that require this type of information therefore rely upon trusted intermediaries to provide it. Such intermediaries place their reputations at stake when

who brought this country to the brink of financial ruin.”). Nonetheless, the complaint itself reflects perceptions at the time of Goldman's conduct as less than appropriate. *See, e.g.,* Gretchen Morgenson & Landon Thomas Jr., *A Glare on Goldman, From U.S. and Beyond*, N.Y. TIMES, Apr. 19, 2010, at B1 (discussing public perceptions of Goldman Sachs' conduct during the financial crisis with a focus on the ABACUS transaction).

11. In referring to trust, we do not characterize this relationship as a legal fiduciary duty but rather as part of the economic fabric of the investment bank's relationship with its clients and as a substitute for a weak contracting environment. Compare FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 91–93 (1991) (asserting that fiduciary duties are contract terms imposed by courts to reflect parties' ex ante expectations), with Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 892–905 (discussing different applications and notions of fiduciary duty beyond the contractual paradigm). *See also* Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439, 442–49 (2010) (terming the current law on fiduciary duties of brokers “confusing”); Robert B. Thompson, *Market Makers and Vampire Squid: Regulating Securities Markets After the Financial Meltdown*, 89 WASH. U. L. REV. 323 (2011) (surveying various fiduciary duty requirements between investment banks and third party customers).

12. The SEC asserted violations of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), Rule 10b-5 promulgated under the Exchange Act, and Section 17(a) of the Securities Act of 1933. SEC Complaint, *supra* note 3, ¶ 6. However, to sustain such a cause of action, the SEC was required to prove that Goldman Sachs had affirmatively misrepresented a fact related to the transaction. Because there was no such statement the SEC could point to in the case of Goldman Sachs, it could alternatively prove that there was a material omission. The SEC's case thus depended on the fact that the defrauded parties here had to have been deceived by an omitted fact material to make other facts misleading. In the case of a Rule 10b-5 and Section 10(b) case, deception was also required to establish scienter, a necessary element of that claim. This implicated the practices and norms of Wall Street and whether Goldman Sachs would normally be required to disclose this information. This raised the issue of whether duties of a fiduciary nature were being imposed on Goldman Sachs. *See generally* Joseph A. Grundfest, *The United States Securities and Exchange Commission v. Goldman, Sachs & Co. and Fabrice Tourre*, ROCK CENTER FOR CORP. GOV. (Apr. 27, 2010) [hereinafter Grundfest Presentation], available at http://www.law.stanford.edu/display/images/dynamic/events_media/SEC%20Goldman%20Complaint%20Analysis_Joe%20Grundfest.pdf (discussing whether fiduciary-type duties should be imposed against Goldman Sachs).

13. Although the earliest investment banks emerged from the transatlantic cotton trade, where the former effect was the most important obstacle to trade, see ALAN D. MORRISON & WILLIAM J. WILHELM, JR., *INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW* 113–14, 141–42 (2008).

they trade; any factor, whether technological or legislative, that undermines the value of a reputation also undermines the intermediary's incentives and, hence, the level of trust that is vested in it.

Historically, investment banks were small, lightly capitalized private partnerships that were largely engaged in advisory work. The quality of client services was hard to measure and almost impossible to prove in court. Reputation, the wellspring from which trust flowed, was the central asset for investment banks. The extent of the investment bank's responsibilities and their legal parameters were clearly understood by banks, clients, and regulators.¹⁴

We show in this Article that technological changes have made some investment banking activities, particularly trading businesses, more susceptible to formal contracting. The incentive to maintain reputation has therefore eroded; trust-based contract has withered for the institutional traders that operate in these businesses, where any action within the formal rules is regarded as fair game. Regulatory input into rule creation is increasingly important in this setting, and the roles of trust and reputation have been massively attenuated, substituted by legal formalities. In such a circumstance, to the extent any regulation is appropriate of investment banking relationships with its counterparties, a gap-filling standard like fiduciary duties should give way to bright-line legal rules.¹⁵

At the same time, trust and reputation are still central to advisory businesses, which remain unsusceptible to codification and formal contracting or rule-making. In these markets, attempts at formal regulatory standards inevitably rely upon imperfect information; they may therefore overturn the reasonable expectations formed by parties to a reputational contract. This lowers the rent that can be derived from a strong reputation and so reduces incentives to maintain reputation. Formal rules or standards in very tacit businesses can therefore undermine the informal mechanisms that promote adherence to trust-based responsibilities which can be characterized as fiduciary in nature without applying the legal formalities of this label. In such circumstances neither codified, bright-line legal rules or legal standards such as fiduciary duties are appropriate.

Between the highly codified activities of the trading room, where formal rules have an increasing role to play, and the very tacit work of the advisory firm, where heavy-handed codification may be counterproductive, lies a range of highly complex transactions that require high levels of technical skill, as well as reputationally intermediated solutions to severe informational problems. The boundary between private interest, where specified contracting is possible, and where it is not, is ambiguous in these complex transactions. As a consequence, so is the appropriate role of the regulator and whether rules or a standard such as fiduciary duties should apply.

The ABACUS transaction is a good example of this more complex environment, although it is by no means exceptional. This Article is an examination of that deal, and its implications for the debate over whether to impose new rules or fiduciary duty standards on investment banks transacting with clients. In the Dodd–Frank Wall Street Reform and

14. *Id.* at 97–120.

15. Such bright-line rules allow for more formal codification and clear delineations of roles and responsibilities that are appropriate in this type of market place. For a further discussion of the propriety of rules versus standards in the context of securities regulation, see James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625 (2007).

Consumer Protection Act, Congress bestowed the power upon the SEC to impose a standard of care on broker-dealer client relationships.¹⁶ On January 21, 2011, the SEC staff released its Study on Investment Advisors and Broker-Dealers, and made a preliminary recommendation that the SEC apply such a standard in retail relationships.¹⁷

This congressional and SEC action was directly spurred by ABACUS and the SEC action. At the time of the controversy, Professor Joseph A. Grundfest of the Stanford Law School and the Rock Center for Corporate Governance predicted the issue when he stated that ABACUS and the related SEC action have put “[t]he question of a broker’s obligations to clients . . . front and center, including the questions of whether brokers should have a fiduciary obligation to clients, and the performance of market-making functions.”¹⁸

In short, increased codification has blurred the distinction between private interest and reputational substitutes. It has resulted in the formation of large full-service banks and, within those banks, it has shifted the power base from the advisory function to the trading room.¹⁹ This has undermined the power of reputational incentives and has made it harder to design appropriate laws. These changes made it increasingly hard during the last decade to reconcile individual interests with those of financial institutions and their clients; we believe that they set the stage for the 2007–09 financial crisis.

This Article examines these changes through the lens of the ABACUS transaction. Part II describes the ABACUS transaction and examines its intended complexity. Part III examines the ABACUS transaction in light of investment banking activities at the time and the expectations of customers. Part IV takes a step backward and places the ABACUS transaction within the historical evolution of the investment bank. Part V concludes by examining whether and how investment banking activities which historically relied on trust and reputation should be substituted for more formal regulatory standards in the form of fiduciary duties.

16. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

17. See SEC, STUDY ON INVESTMENT ADVISERS AND BROKER–DEALERS AS REQUIRED BY SECTION 913 OF THE DODD–FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2011) [hereinafter SEC BROKER STUDY], available at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>. The study was released with a joint statement by Commissioners Casey and Paredes asserting that any imposition of such duties was too preliminary and required further empirical study. See Kathleen L. Casey & Troy Paredes, SEC Commissioners, Statement Regarding Study On Investment Advisors And Broker-Dealers (Jan. 21, 2011), available at <http://www.sec.gov/news/speech/2011/spch012211klctap.htm>.

18. Grundfest Presentation, *supra* note 12, at 16. For prior legal analysis of this issue in a comparative context, see Andrew Tuch, *Investment Banks as Fiduciaries: Implications for Conflicts of Interest*, 29 MELB. U. L. REV. 478 (2005). See also Steven M. Davidoff et al., *Fairness Opinions in Mergers and Acquisitions*, in THE ART OF CAPITAL RESTRUCTURING 483, 488 (H. Kent Baker ed., 2011) (discussing the fiduciary duties of investment bankers in rendering fairness opinions).

19. MORRISON & WILHELM, *supra* note 13, at 301–04.

II. THE ABACUS DEAL

A. *The Critical Dispute*

Although the details of the ABACUS deal are intricate matters of corporate finance, the idea underpinning it is simple. In late 2006, the hedge fund manager John Paulson approached Goldman Sachs seeking to establish a short position on a portfolio of Baa2-rated 2006-vintage residential mortgage-backed securities (RMBS).²⁰ Because the transaction was initiated by Paulson rather than by Goldman Sachs, Paulson's initial request was termed a "reverse inquiry."²¹ Goldman Sachs identified counterparties for the transaction with Paulson and, because the trade was a complex one, served as an intermediating counterparty for the trade with all of the participants.²² Goldman Sachs did not lay off all of the exposure to Paulson's trade and so retained a small long position in the portfolio of RMBS.²³

The ultimate counterparties to Paulson's trade were the German bank IKB Deutsche Industriebank AG (IKB), and ACA Management LLC (ACA).²⁴ ACA had significant expertise analyzing RMBS credit risk, and, in addition to assuming long-side RMBS risk, they agreed for a fee to select the reference portfolio of RMBS.²⁵ In fact, Paulson also played a significant role in selecting the portfolio. This fact is not contested.²⁶ In 2007, participation in the reference portfolio selection process by the party bearing the most economic risk was not unusual in this type of transaction. Nevertheless, the SEC claimed that Goldman Sachs' marketing materials were false and misled investors by representing "that ACA selected the reference portfolio while omitting any mention that Paulson . . . played a significant role in the selection of the reference portfolio."²⁷

Goldman Sachs was also alleged to have "misled ACA into believing that Paulson was investing in the equity of ABACUS 2007-AC1 and therefore shared a long interest with CDO investors."²⁸ The reference to "equity" here has a specific meaning that we discuss below; the allegation suggested that ACA believed that Paulson held a very risky long position in the portfolio, and hence that he was confident of its quality.²⁹ The SEC further alleged that, had ACA been aware of Paulson's short position, it would have been reluctant to have Paulson participate in the selection process for fear of damaging its reputation and would likely not have served as portfolio selection agent.³⁰

20. Goldman Sachs Submission, *supra* note 9, at 11.

21. *Id.*

22. *Id.* at 11–13.

23. *Id.* at 14–15.

24. SEC Complaint, *supra* note 3, ¶¶ 58, 61.

25. Goldman Sachs Submission, *supra* note 9, at 7.

26. *Id.* at 11–12; SEC Complaint, *supra* note 3, ¶ 2.

27. SEC Complaint, *supra* note 3, ¶ 36.

28. *Id.* ¶¶ 32, 44.

29. The complaint supports this allegation by referring to the memorandum in which the ACA Commitment Committee approved the deal, and described Paulson as an investor "in the 0-9% tranche of a static mezzanine ABS CDO backed 100% by sub prime residential mortgage securities." *Id.* ¶ 51.

30. *Id.* ¶ 45.

B. Deal Structure

The context of the SEC's actions can be best understood in light of a more detailed explanation of the transaction illustrated in Figure 1. At the heart of both the deal and the SEC's complaint is a portfolio of \$2 billion of RMBS. This comprised 90 equal-sized Baa2-rated securities, originally issued in 2006.³¹ The design of this portfolio was initiated by Goldman Sachs, who provided Paulson with a spreadsheet listing securities that reflected Paulson's rating and vintage preferences.³² He suggested 123 securities for inclusion in the reference portfolio.³³ In early January 2006, ACA began meeting with Paulson and Goldman Sachs representatives to negotiate the structure of the reference portfolio. ACA rejected more than half of the original 123 securities suggested by Paulson.³⁴ Negotiations continued over the course of the next month³⁵ and, according to Goldman Sachs' September 10, 2009 response to the SEC's Wells notice, included IKB.³⁶ ACA's Commitments Committee approved participation as the selection agent on February 12, 2007.³⁷ "On or about February 26, 2007," ACA and Paulson agreed to a reference portfolio containing 90 RMBS bonds of the risk and vintage sought by Paulson.³⁸

The deal was structured as a securitization. In a traditional securitization, an economic agent transfers its ownership of a portfolio of real or financial assets that it has originated to a new company, or "Special Purpose Vehicle" (SPV). The SPV issues notes backed by the cash flows generated by the bonds, and returns the proceeds from the notes to the originating agent. Transferring the assets to a SPV ensures that the securitization deal is unaffected by the bankruptcy of the originating agent, and, similarly, that holders of securitized notes have no claim upon the originating agent after a payment default.³⁹

The ABACUS transactions were *synthetic* securitizations. Synthetic securitizations were originally a response to the cost and legal complexity of transferring the originator's assets to the SPV in a traditional securitization. Instead, the originator in a synthetic deal keeps the assets on its balance sheet, and is indemnified against losses on those assets by the SPV, via a transaction called a "credit default swap."⁴⁰ The SPV's indemnification is credible because it invests the proceeds from the notes it sells in high-quality securities upon which the originator has first claim after default. In exchange for providing protection against default loss, the SPV receives regular payments from the originator, which are used to enhance the returns generated by the collateral securities, and so

31. Goldman Sachs Submission, *supra* note 9, at 11.

32. *Id.* at 12–13.

33. *Id.*

34. *Id.*

35. SEC Complaint, *supra* note 3, ¶¶ 26–35, 46–51.

36. Goldman Sachs Submission, *supra* note 9, at 24.

37. SEC Complaint, *supra* note 3, ¶ 51.

38. *Id.* ¶ 35.

39. See generally CHARLES AUSTIN STONE & ANNE ZISSU, THE SECURITIZATION MARKETS HANDBOOK: STRUCTURES AND DYNAMICS OF MORTGAGE- AND ASSET-BACKED SECURITIES (2005) (providing a description of asset securitization); TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSET POOLS, AND ASSET-BACKED SECURITIES (1991 & Supp. 1994) (same); STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (2d ed. 1993) (same).

40. See Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1028 n.22 (2007).

compensate the note holders for the risk of default.⁴¹

The ABACUS deal has many of the features identified above. As discussed above, and illustrated in Figure 1, there is a reference portfolio of 90 2006-vintage, Baa2-rated securities. The SPV, a Cayman Island-incorporated vehicle, created notes backed by these assets for sale to investors. These are organized in a standard “waterfall” structure, under which notes in the hierarchy illustrated in the Figure are senior to those below them. Hence, the \$1.1 billion Super Senior Tranche incurs no losses until everything below it has been wiped out, the \$0.2 billion of A-1 notes incur losses only after A-2 note-holders have lost everything, and so on. The FL, or “First Loss,” notes are the riskiest, and are the fraction of the portfolio that the SEC referred to as “equity.”⁴²

Proceeds from the sale of ABACUS notes were used to purchase collateral securities, and these were used to collateralize a credit default swap with the originator, Goldman Sachs, under which the ABACUS SPV protects Goldman Sachs against losses incurred on the reference portfolio.⁴³ Goldman Sachs also provided some hedging trades to the SPV (basis swaps and collateral puts), which we do not illustrate.⁴⁴

The ABACUS transaction has two important features. First, none of the parties to the transaction actually owns the reference portfolio. Compensation payments under the credit default swap are based upon the default losses that a holder of the reference portfolio would have experienced, had he existed. The payments that Goldman Sachs received under the terms of its credit default swap therefore represented profit, not compensation. It passed these profits on by trading an opposing credit default swap with the same reference portfolio with Paulson.⁴⁵

The second important feature of this transaction was that not all of the notes that ABACUS established were sold. In the event, only IKB and ACA invested before the deal closed on April 26, 2007: ACA bought \$42 million of the A-1 notes, and IKB bought \$8 million of the A-1 notes and \$142 million of the A-2 notes.⁴⁶ The losses from these notes were again calculated as they would have been had every note been sold. In practice, therefore, neither Paulson nor anyone else held the equity for this transaction. The collateral portfolio consisted of \$192 million of securities.⁴⁷ A securitization deal of this type, which does not generate sufficient funds to purchase the reference portfolio, is referred to as an *unfunded* transaction.⁴⁸

The sale of the A-1 and A-2 notes ensured that they could be rated, and both received a Aaa rating.⁴⁹ The Super Senior Tranche, which had higher seniority than either, was therefore at least of AAA quality. Paulson wanted to short this part of the deal; that is, to profit to the extent that defaults exceeded 45% of the notional value of the \$2 billion reference portfolio.⁵⁰ He established this position by entering into a credit

41. See generally STANDARD & POOR'S, GLOBAL CASH FLOW AND SYNTHETIC CDO CRITERIA (2002) [hereinafter S&P GUIDELINES], available at <http://creditrisktransfer.free.fr/doc/sp.cdo.pdf>.

42. SEC Complaint, *supra* note 3, ¶ 4.

43. Goldman Sachs Submission, *supra* note 9, at 10.

44. *Id.*

45. *Id.*

46. *Id.* at 2; Figure 1.

47. Goldman Sachs Submission, *supra* note 9, at 14.

48. S&P GUIDELINES, *supra* note 41.

49. SEC Complaint, *supra* note 3, ¶ 58.

50. Goldman Sachs Submission, *supra* note 9, at 14–15.

default swap with Goldman Sachs, referenced by the Super Senior Tranche of the ABACUS reference portfolio. This CDS is illustrated at the top of Figure 1. Goldman Sachs was unable to pass the whole of this position on, but ACA was willing to sell default protection on the safest \$1 billion of the Super Senior Tranche. Goldman Sachs was unwilling to accept ACA's credit risk without collateral, so ACA's parent, the Dutch bank ABN AMRO, intermediated the trade.⁵¹ Goldman Sachs was therefore exposed on this CDS only if reference portfolio losses exceeded 50%, and both ABN AMRO and ACA failed.

Note that the chain of \$1.1 billion CDS transactions was independent of the ABACUS transaction, although, like the ABACUS transaction, it referenced the Super Senior Tranche of a portfolio that no one held, and which was used only to determine the profits and losses of deal counterparties. Paulson paid Goldman Sachs a 1% upfront fee to open this transaction, and 85 basis points per year (about \$18.5 million for the first year).⁵² Goldman Sachs' only market exposure to the transaction was to the \$91 million of Super Senior Tranche CDS that it was unable to lay off,⁵³ in the event, it lost the whole of this sum. Estimates of Paulson's profits are around the \$1 billion mark.⁵⁴

C. Justifying Complexity

The ABACUS transaction required some complicated financial plumbing. Why was it necessary? In particular, why could Paulson not simply establish a short position by trading directly with Goldman Sachs?

Had Goldman Sachs taken the long side of Paulson's short, it would have assumed a significant economic exposure to the RMBS market. Goldman Sachs' credibility as a counterparty in risky trades reflects in part its risk capital, which is limited; assuming a position in the RBMS market would tie up risk capital, and constrain Goldman Sachs' ability to participate in other transactions. Much of Goldman Sachs' value derives from its ability to use its market knowledge and contacts rapidly to structure deals, and this type of structuring is the most efficient use of its risk capital. Hence, it is more efficient for Goldman Sachs and similar institutions to recycle capital to support future originations, rather than to use it to hold long-term positions in the RBMS and other asset markets.⁵⁵ It is therefore natural that Goldman Sachs should seek the most efficient

51. At the same time, Goldman Sachs provided ABN with \$27 million of CDS protection against default by ACA. See *Wall Street and the Financial Crisis: The Role of Investment Banks: Hearing Before the Permanent Subcomm. On Investigations of the S. Comm. On Homeland Sec. and Gov't Affairs*, 111th Cong. Exhibit #125 (2010) [hereinafter *Investment Banks Hearing*], available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_senate_hearings&docid=f:57322.pdf.

52. *Id.*

53. This related to default losses on the Super Senior Tranche arising as a result of defaults of between 45% and 50% of the value of the reference portfolio; losses beyond 50% were covered by the ABN AMRO CDS trade. See GOLDMAN, SACHS & CO., ABACUS 2007-ACI, LTD. OFFERING CIRCULAR 3 (2007), available at <http://www.scribd.com/doc/30414220/ABACUS-Offer-Document>. Goldman Sachs continued to market this "junior super senior note" at least until June 5. See *Investment Banks Hearing*, *supra* note 51, at Exhibit #126.

54. SEC Complaint, *supra* note 3, ¶ 5.

55. See generally A. Perold, *Capital Allocation in Financial Firms*, 17 J. APPLIED CORP. FIN. 110 (2005) (discussing capital allocation by financial firms). Note that our discussion ignores the potential for diversification or netting opportunities with respect to the bank's existing book. It is possible that Goldman Sachs was able to exploit such opportunities to mitigate some of its risk from the unsold Super Senior CDS.

mechanism to pass on its transaction risk: this mechanism appears to have been the ABACUS transaction.

A secondary consideration was Paulson's need for liquidity. The notes issued by ABACUS could be rated because they were based upon a CDS swap with a rated counterparty. A straightforward bilateral transaction between Goldman Sachs and Paulson would have been unrated since it was a private transaction, and, hence, would have been less easy for third parties to evaluate. As a result, it would have been harder for Paulson to exit such a transaction before its maturity. In short, if we accept that developed capital markets should enable traders like Paulson to take short positions, we should expect efficient mechanisms for doing so to emerge. ABACUS appears to have been such a mechanism.

III. CONFLICT AND AMBIGUITY IN ABACUS

It is clear even from the simplified discussion of Part II that the ABACUS SPV sat at the heart of a web of very complex transactions. What were Goldman Sachs' obligations as facilitator of these deals? Was it simply an intermediary between sophisticated and willing traders? Or did it assume responsibilities, legal or trust-based, to the parties of the ABACUS transactions, and then abnegate its responsibilities to IKB and ACA by failing to communicate Paulson's intentions to them?

A. Transactional Perspectives on Trade

It would be easy to answer these questions if Paulson had simply used Goldman Sachs as a broker when shorting an exchange-traded stock. While there is some debate as to whether short-selling destabilizes markets or strengthens them, the practice is legal.⁵⁶ Brokers are not required to reveal short sellers' intentions; indeed, for exchange-related transactions they are required not to reveal them, and instead "to maintain the confidentiality of client information."⁵⁷ The broker's clear obligation in this case is to the stock seller, and not to the buyer.

Can we think of the ABACUS deal as a more complicated version of the short-selling discussed in the preceding paragraph? That is, can we adopt a purely *transactional* perspective on the ABACUS deal? As far as we know, there is no evidence to suggest that Paulson was acting on information available only to him. Indeed, several other commentators were arguing at the time of the deal that the U.S. housing market was over-inflated.⁵⁸ Paulson simply backed his opinions with hard cash. ACA and IKB clearly had an opposing perspective, but it does not appear to have been based upon inferior data.

56. For a discussion of these issues, see Amendments to Regulation SHO, Exchange Act Release No. 34-61595, 75 Fed. Reg. 11,231 (Mar. 10, 2010) (to be codified at 17 C.F.R. pt. 242), which discuss the market impact of shortselling, the history of short sales regulation in the United States, and a 2009 SEC proposal to reevaluate the need for additional restrictions.

57. *In re Thomas W. Heath, III*, Exchange Release Act No. 34-59,223, 2009 WL 56755, at *4 (Jan. 9, 2009). The requirement in the *Heath* case was under NYSE Rule 476(a)(6) and its obligation that a member's "conduct [be not] inconsistent with just and equitable principles of trade." *Id.* at 3.

58. See generally GREGORY ZUCKERMAN, *THE GREATEST TRADE EVER: THE BEHIND-THE-SCENES STORY OF HOW JOHN PAULSON DEFIED WALL STREET AND MADE FINANCIAL HISTORY* (2010) (recounting competing views of the state of the housing market in the period leading up to the financial crisis).

Both ACA and IKB were long-standing in this market; if one adopts a transactional perspective on the ABACUS deal, one could argue that, as professional traders, neither ACA nor IKB needed the protection of the SEC or the federal securities laws. Both could negotiate for the contractual protections they desired without need for legal default rules. Conversely, in a transactional setting, sophisticated parties do not rely upon trust-based relationships to fill any gaps in the securities laws due to the ability to demand and negotiate equivalent protections. In plain English, ACA or IKB could have asked for this information and refused to trade if it was not provided or represented. They chose not to.

If Paulson was not trading on inside information, which creates its own affirmative disclosure obligations, did Goldman Sachs have an obligation to inform ACA and IKB of his intentions with respect to this deal?⁵⁹ If the analogy with quoted stock short-selling holds, then the answer is surely that Goldman Sachs had *neither* a legal nor a reputational obligation to lay bare its client's short-selling. The strength of the transactional analogy is therefore critical as it defines the expectations of the parties.

Every party to the deal knew the identity of the reference securities, which were described in the offering document.⁶⁰ Whether every counterparty understood Paulson's role in selecting the securities is contested.⁶¹ But the instigator of a stock short sale selects the stock, and its counterparties do not know that it has chosen to short it. Hence, if we adopt a purely transactional perspective on the ABACUS deal, Paulson's intentions were not germane. Similarly, whether he retained the equity portion of the deal would be irrelevant if the deal were treated as a series of arm's length transactions, since Paulson could easily reverse any position in a liquid market, and would not then be expected to report his actions to every prior counterparty.

In short, a transactional perspective would justify the actions of all parties to these deals by arguing that they knowingly entered into a contract for which they had shared design responsibility, and which additionally was documented in accordance with practices comporting with the federal securities laws. The only potentially useful information that may have been imperfectly revealed to ACA and IKB was Paulson's trading strategy. But, from a transactional perspective, this was the only piece of information that Goldman Sachs, as Paulson's broker, was explicitly expected *not* to reveal. The ABACUS deal originated on a trading desk, and transactional attitudes to trade naturally predominate on trading desks. Perhaps it is unsurprising that the main source of conflict with the SEC was over what Goldman Sachs did and did not reveal about Paulson. But the SEC's case was attenuated because while explicit enforcement of the anti-fraud rules for misstatements here was appropriate, there was no misstatement, and no party should have expected that the controversial role of Paulson should have been disclosed absent the imposition of some fiduciary-like, objective standard on this transaction. But as we will argue below, such duties are inappropriate in this context either as a reflection of the parties' expectations or as a matter of economic theory.

59. For a discussion of insider trading rules and obligations, see WILLIAM K. S. WANG & MARC I. STEINBERG, *INSIDER TRADING* 1–8 (3d ed. 2010).

60. See ABACUS FLIPBOOK, *supra* note 3.

61. SEC Complaint, *supra* note 3, ¶ 2.

B. Trust-Based Agreements

This argument suggests that as a predicate to the SEC's complaint, its case must rest on a non-transactional view of the ABACUS deal. If ABACUS was based on complex, *trust-based* agreements, then, arguably, Goldman Sachs had reputational responsibilities to its counterparties that ran deeper than its obligations under arms-length transactions. The question still remains, though, whether legal formalities should be imposed either through formal rules like the federal securities laws or the gap-filling standard of fiduciary duties.

A trust-based perspective is more appropriate than a transactional view in two types of economic situations. The first is where critical information cannot be observed, or cannot form the basis of a formal legal contract. In this situation arms-length trade may be impossible, because both parties to the trade are unable to trust their opposite number to take the actions that make trade worthwhile. This type of non-contractibility lay at the heart of corporate finance for the whole of the 19th century, and for most of the 20th century; it remains important today. A failure to resolve it results in significant economic losses: for example, it is probably impossible to write a formal contract referencing the quality of an entrepreneur's business plan, or the productivity with which he works. Hence, entrepreneurs who cannot rely upon trust-based agreements to persuade investors that their ideas are strong, and that they will not waste investment on questionable pet projects, cannot attract the capital required to develop their ideas. A failure to fund the entrepreneurial sector then undermines innovation and economic progress.

The investment bank's historic *raison d'être* was to resolve conflict in situations where the formal law was ineffective. It did so by staking its reputation on promises to both parties to a transaction.⁶² Because both parties trusted it, the investment bank received fees for making these promises and, because it valued the fees that sprang from its continued trustworthiness, it worked hard to make meaningful promises, and to maintain its reputation.

Trust-based transactions are also important in situations where, although information about the quality of traded goods or about the actions of a counterparty is observable, it is costly and difficult for one party to a transaction to perform the observation. In such situations, a trusted intermediary can put its reputation at stake by guaranteeing the quality of goods, or by guaranteeing its own or another counterparty's behavior. Once again, concern to maintain the stream of rents that flow from this type of deal keeps the reputational intermediary honest. Furthermore, devolving informationally intensive activities to a specialist reduces the costs of doing business and, once again, raises efficiency and welfare.

This type of intermediation is also practiced by investment banks when, for example, they undertake to provide accurate information about a securities offering or about the quality of a stock tender offer. It is also central to the credit ratings industry, to auditing, and even to the news media, all industries which exist to provide accurate information.

We have argued that there was a clear transactional component to the ABACUS deal, and that the deal involved no information that was not somewhere in the public

62. MORRISON & WILHELM, *supra* note 13, at 265–67.

domain.⁶³ Nevertheless, there may have been an element of the second type of trust-based trade involved in the transaction. This was the case if any party to the deal based its decisions upon beliefs about the behavior of Goldman Sachs, or about the quality of the trades that Goldman Sachs intermediates. To the extent that this happened, Goldman Sachs was trading on its reputation, rather than serving as an arm's length broker in a transactional marketplace. If that was the case, Goldman Sachs was balancing the interests of the various parties to the ABACUS deal, rather than merely representing one of them.

To determine perfectly whether the ABACUS deal involved an element of trust-based trade, we would need to observe the beliefs of the parties to the deal. This is difficult: absent direct evidence, ex post statements of beliefs and intentions are hardly credible, particularly when so much rides upon them. But we can attempt to understand the norms that prevailed in the securitization markets in 2007. Did market players think that their investment bank counterparts were placing their reputation on the line when they traded, and did they make investment decisions accordingly? Did investment banks attempt to trade on their reputations?

Reputation certainly played an important part in the securitization markets in the first decade of this century. We know, for example, that many sophisticated investment funds relied upon the assessments of reputable credit ratings agencies rather than their own analysis when investing in securitizations.⁶⁴ Whether this was an efficient decision or a failure of fiduciaries to shoulder their responsibilities is open to question. But it is harder to make a clear case that investment banks made tacit promises about the quality of the assets that they securitized. They certainly needed reputations as competent and reliable market makers, as technical savants, and even as experts in arcane regulations. But we are unaware of any convincing evidence that investment banks staked their reputations on statements about the likely performance of the securitized investments that they structured. We are thus skeptical that the norms and practices of the time justified anything but a transactional approach to the ABACUS transaction. However, the failure of market observers and regulators, such as the SEC, to recognize the changes in the investment-banking industry may have led them to a different conclusion.

Two questions arise in this context. First, why have investment banks turned away from trust-based transactions in complex deals like ABACUS? Second, how should regulators and supervisors respond to this type of complexity?

63. See *supra* Part III.A.

64. See John Ammer & Nathanael Clinton, *Good News is No News? The Impact of Credit Rating Changes on the Pricing of Asset-Backed Securities* (Fed. Reserve Bd., Int'l Fin. Discussion Paper No. 809, 2004), available at <http://www.federalreserve.gov/pubs/ifdp/2004/809/ifdp809.htm> (assessing the impact of credit ratings on the pricing of structured financial products); Maciej T. Firla-Cuchra, *Explaining Launch Spreads on Structured Bonds* (University of Oxford Dep't of Econ., Discussion Paper No. 230, 2005), available at <http://www.economics.ox.ac.uk/Research/wp/pdf/paper230.pdf> (demonstrating the importance of ratings in explaining variation of credit spreads in structured notes); Alan D. Morrison, *Ratings Agencies, Regulation and Financial Market Stability*, in VERDICT ON THE CRASH: CAUSES AND POLICY MAKERS (Phillip Booth ed., 2009) (discussing the issues associated with credit ratings agencies).

IV. THE MANAGEMENT OF INVESTMENT BANKS

The publicly quoted investment bank is a recent phenomenon. Prior to 1971, all investment banks were partnerships or closely-held private firms.⁶⁵ Even after the New York Stock Exchange (NYSE) changed its rules and permitted investment banks to float, the blue-blooded wholesale banks retained the partnership form until the mid-1980s. Goldman Sachs did not float until 1999.⁶⁶

Some commentators have suggested that the crisis of 2007–09 can be attributed to the demise of the partnership form on Wall Street.⁶⁷ Former partners at Goldman Sachs and Morgan Stanley have argued that bankers have better incentives in partnerships, where their own fortunes depended upon the continuing success of the firm, than in joint stock corporations.⁶⁸

We think that it is probably true that investment bankers had stronger reputational incentives in the partnerships of 25 years ago than they do today. Their wealth was tied up in the firm, and it was extremely hard to extract.⁶⁹ Any loss to the firm's reputation affected its ability to generate fee income and hit the value of their partnership stake. Hence, as Gus Levy of Goldman Sachs has said, they were forced to be "long-term greedy": the need to protect the firm's reputation informed every one of its partners' decisions.⁷⁰

Investment bankers appear to have changed their focus in the last two and a half decades. For example, Lloyd Blankfein, Chairman and CEO of Goldman Sachs, appeared to focus upon the transactional role of investment banks in his recent testimony to the U.S. Congress.⁷¹ Mr. Blankfein stressed Goldman Sachs' trading function in dialogue

65. Alan D. Morrison & William J. Wilhelm, *The Demise of Investment Banking Partnerships: Theory and Evidence*, 63 J. FIN. 311 (2008).

66. See MORRISON & WILHELM, *supra* note 13, at 276–80 (describing the decline of investment banking partnerships in favor of the limited liability corporate form).

67. See Steven M. Davidoff, *A Partnership Solution for Investment Banks?*, N.Y. TIMES DEALBOOK, Aug. 20, 2008, <http://dealbook.nytimes.com/2008/08/20/a-partnership-solution-for-investment-banks/> (proposing that a partnership structure for investment banks could prevent them from taking undue risk); Claire A. Hill & Richard W. Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE U. L. REV. 1173 (2010) (arguing that excessive risk taking leading up to the financial crisis was attributable to a lack of personal responsibility and liability for investment bankers previously found in the partnership form); Michael Lewis, *The End*, PORTFOLIO.COM (Nov. 11, 2008), <http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom> (discussing the strengths of the partnership form over the limited liability investment banking model in the context of the financial crisis); Larry Ribstein, *Governance, the unincorporation and subprime*, IDEOBLOG (Aug. 23, 2008), <http://busmovie.typepad.com/ideoblog/2008/08/governance-the.html> (arguing that the problems with subprime mortgages during the financial crisis illustrated the importance of the partnership form over the corporate form in aligning incentives and risk-taking at investment banks).

68. See Christine Harper, *Wall Street Shareholders Suffer Losses Partners Never Imagined*, BLOOMBERG (Feb. 11, 2011), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a8wXme0GUnc0>.

69. MORRISON & WILHELM, *supra* note 13, at 268–73.

70. In 1976, when John Weinberg became co-chair of Goldman Sachs, he wrote down 14 core business principles for the firm, of which the second was, "our assets are our people, capital and reputation. If any of these is ever diminished, the last is the most difficult to restore." *Goldman Sachs Business Principles*, GOLDMAN SACHS, <http://www.goldmansachs.com/who-we-are/business-standards/business-principles/index.html> (last visited Mar. 25, 2012).

71. See *Investment Banks Hearing*, *supra* note 51, at 134 (statement of Lloyd C. Blankfein, Chairman and

with Senator Levin, stating that “we are a part of a market process. We do hundreds of thousands, if not millions of transactions a day as a market maker.”⁷²

Mr. Blankfein drew a distinction in his testimony between transactional business and trust-based trade. For example, when asked by Senator Levin whether Goldman Sachs is conflicted when it sells a security that it plans to short, Mr. Blankfein responded:

In the context of market making, that is not a conflict. What clients are buying . . . is . . . an exposure. The thing that we are selling to them is supposed to give them the risk they want. They are not coming to us to represent what our views are. . . . They shouldn't care.⁷³

Mr. Blankfein's testimony indicates that he views the transparency of securitization trades in the transactional way that we have argued is characteristic of stock exchange transactions: “[T]he markets work on transparency with respect to what the item is. It doesn't carry representations Just think of buying from a stock exchange or a futures market. You are not even supposed to know who is on the other side.”⁷⁴

Mr. Blankfein's arguments stress the transactional perspective on banking that we attributed in Part II to trading rooms. And, in line with this observation, Mr. Blankfein's background is in sales and trading.⁷⁵ His March 2009 appointment as CEO coincided with the departure of Jon Winklereid, a traditional banker and co-president of the firm with Garry Cohn, a trader. After Blankfein's arrival, Goldman Sachs was controlled for the first time entirely by traders.

A recent *New York Times* opinion article discusses the change that resulted in Blankfein and Cohn's ascendancy. One former senior Goldman Sachs partner is quoted as saying, “Not so long ago, if there was a choice between making a quick buck or protecting client relationships, we would side with the client every single time.”⁷⁶ The same former partner goes on to say:

The guys who succeed in this industry are the guys who say, “I care about the reputation of the firm I care about my reputation. I care about doing the right thing. I care about having a great firm. I care about attracting and retaining the best people. . . .” But in this top five, there is nothing about making money. The guys for whom making money is in the top three almost always get themselves into trouble. And this is the essence of how Goldman has changed.⁷⁷

Goldman Sachs has always been acutely aware of the importance of its culture and of its people. It is highly unlikely that the firm would undergo a cultural shift from a trust-based, relationship-oriented business model to a more transactional model

Chief Executive Officer, Goldman Sachs Group, Inc.).

72. *Id.* at 139.

73. *Id.* at 134.

74. *Id.* at 135.

75. See Jeffrey M. Cunningham & Anna Snider, *Lloyd Blankfein: A Profile*, FORBES (Dec. 16, 2009), <http://www.forbes.com/2009/12/16/lloyd-blankfein-goldman-leadership-managing-directorship.html> (recounting Mr. Blankfein's professional history).

76. William D. Cohan, *Goldman: Still Greedy, No Longer Patient*, N.Y. TIMES OPINIONATOR BLOG (Apr. 29, 2010, 6:51 PM), <http://opinionator.blogs.nytimes.com/2010/04/29/goldman-still-greedy-no-longer-patient/>.

77. *Id.*

accidentally and without a great deal of thought and introspection. To the extent that this change has occurred, it reflects economic imperatives. It is a response to technological change and, in particular, to changes in information technology.

The arrival on Wall Street of cheap computing had profound implications. In the first instance, it affected retail-oriented banks with high back office volumes, and it had relatively little impact upon wholesale banks like Goldman Sachs. But powerful desktop computers enabled wholesale banks to measure and to record data that previously had to be taken on trust. It enabled banks to adopt academic models like the Black-Scholes formula for option valuation, and to build financial engineering businesses that rested upon these models.⁷⁸ Financial engineering and better information technology were both substituted for the trust-based intermediation that formerly was at the heart of investment banking business. Activities that previously had been the sole preserve of the relationship banker shifted increasingly to the trading room.

Computerization and financial engineering slowly shifted the center of gravity within investment banks from the relationship managers to the trading room. Goldman Sachs, which was traditionally a very relationship-oriented bank, resisted this shift for longer than other bulge-bracket banks, but it was no more able to hold back the economic tide than its competitors. Its 1999 flotation gave it access to the high levels of financial capital needed to operate at the scale that the new, trading room-oriented business model required. The concomitant cultural shift reflected the new way of doing business.

We have already argued that the transactional, trading room-oriented business model relies more upon technical competence than upon tacit, trust-based contracting. The general industry shift towards transactional business therefore appears to suggest that the relative value of investment bank reputation in businesses like securitization has dropped over the last two decades, because clients rely upon it less when they make investment decisions. If this hypothesis is correct, we should expect Goldman Sachs to experience little damage to its client relationships as a consequence of the publicity surrounding the ABACUS transaction. As yet, we have seen no hard evidence on this point.⁷⁹ One striking datum, apparently supportive of our hypothesis, comes from Professor Grundfest, who presents some (rather preliminary) survey evidence that people with more understanding of the securitization market are far less likely to think that Goldman Sachs is guilty of any misdemeanor.⁸⁰ This suggests that, in a transaction-oriented market place, counterparties evaluate Goldman Sachs along technical and competence-oriented lines, rather than according to its ability to sustain trust-based private contracts.

In short, it may be that Goldman Sachs was not perceived in the transaction-oriented securitization market to be placing its reputation for tacit contracting at risk. If this is the case, its reputation will not be harmed by the revelation that it behaved in the

78. See ROBERT BOOKSTABER, *A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION* (2007) (discussing the transformation of trading desks at investment banks in the wake of computerization).

79. In contrast, the damage in the arena of public opinion appears to be quite real. See Felix Salmon, *BP: Still not as evil as Goldman Sachs*, REUTERS, June 11, 2010, <http://blogs.reuters.com/felix-salmon/2010/06/11/bp-still-not-as-evil-as-goldman-sachs/> (commenting on an informal index based on opinions of the Goldman Sachs brand showing that it had a high negative public approval rating); Thompson, *supra* note 11, at 323–29 (discussing the 2010 Senate hearings criticizing Goldman Sachs and the ABACUS transaction).

80. Grundfest Presentation, *supra* note 12.

securitization market as it would have done were it representing a client in a stock market transaction. If Goldman Sachs was making decisions and conducting its business in a way that would have been unthinkable 30 years ago, then it was also taking a smaller risk with its reputation today than would have been the case then.

As large investment banks embrace transactional modes of doing business and the relative importance to them of trust-based trade diminishes, the expectations that their counterparties have of those investment banks change accordingly. While this allows them to perform liquid securitization trades without risking their franchise value, it may undermine their ability to undertake reputationally intermediated trust-based trade: if clients do not believe that a bank is risking its reputation on a deal, then it cannot profit from doing so. It is therefore very difficult to sustain close relationship-based modes of economic interaction within organizations that also perform high volumes of arm's length transactional business. Nevertheless, relationship-based business remains important in situations characterized by poor information and conflicts of interest. Intermediaries that can stake their reputations against the satisfactory resolution of these conflicts remain economically important. Bulge-bracket banks continue to serve a purpose in this environment, but they now compete with small "boutique" banks.

Boutique investment banks have become important in the last two decades, as their larger competitors have struggled to reconcile transactional and trust-based trade. While some commentators have argued that boutique banks are successful because they avoid conflicts of interest, we do not think that this is a completely accurate characterization of their business model.⁸¹ Boutique banks are important in situations where conflicted interests are inevitable, and where these conflicts cannot be resolved through arm's length contracts. Boutique firms do not avoid this type of conflict. But they *do* steer away from the transactional style of trade at the heart of the ABACUS transaction. In doing so, boutique banks ensure that nothing dilutes the reputational incentives that make them credible in conflicted situations.

If transactional and trust-based trade are uneasy bedfellows, what conclusions should we draw for regulation? In particular, can law substitute for the attenuated private reputational incentives of bulge bracket investment banks vis-a-vis their counterparties? We turn to this question in the following Part.

V. REGULATING MODERN INVESTMENT BANKING RELATIONSHIPS

Investment banking has been transformed by simultaneous advances in computer technology, financial engineering, and financial contracting. The extent of the investment bank's purely transactional business has expanded, and the center of mass for the modern investment bank is now in its dealing room. At the same time, trust-based trade remains important in traditional banking businesses where information is hard to come by and service quality is difficult to record. A successful system of financial regulation has to accommodate both modes of trade without impeding either.

Increased computerization and information codification within banks has generated more hard data upon which regulations can be based. For example, all large banks now

81. See MORRISON & WILHELM, *supra* note 13, at 304-07 (discussing the reasons for the rise of boutique investment banks).

use something like a Value at Risk (VaR) system for risk control, and often for capital allocation as well.⁸² Regulators have taken advantage of the information generated by VaR systems, incorporating the data into capital adequacy calculations.⁸³ VaR-type metrics also feature in modern supervisory approaches to operational risk: that is, to the risk that losses will arise because of fraud, poor systems, or other failures of execution.⁸⁴

VaR systems are valuable tools, which were unfeasible before the advances in computer science and financial engineering of the last two decades. Nevertheless, for at least two reasons, we should tread carefully when we introduce VaR metrics into financial regulation. First, regulation is usually regarded as necessary in situations where market participants will ignore some important consequences of their actions. To the extent that VaR models are used by bankers, they measure the things that bankers care about. It is not clear that regulators can use them to identify the important systemic effects that bankers do not care about.

The use of VaR in formal regulations gives rise to a second concern: namely, that in focusing on the things that they can measure, regulators may downplay or ignore the things that they cannot. As a result, the tacit may come to play a diminishing role in financial regulation. In other words, because bankers were increasingly concerned with the codifiable at the expense of the tacit, so were regulators. To the extent that this allowed supervisors to better understand regulated institutions, this was a desirable measure; to the extent that it resulted in the loss of socially valuable tacit knowledge, it represented a subtle form of regulatory capture.

The recent regulatory emphasis upon the codifiable may reflect practice in the investment banking market, but, in turn, it has had an effect upon regulations and, hence, the behavior of the regulated. When a regulated firm is evaluated on the basis of codified information generated by a computer system its behavior is affected in two ways. The first, and most obvious, is that it may over-invest in activities that are measured by the regulator, and under-invest in others. Frank Partnoy argues that this happened in the credit markets: he suggests that investors were prepared to accept potentially unreliable credit ratings in the run-up to the financial crisis because they were permitted by regulation only to invest in rated products.⁸⁵ Hence, Partnoy argues that the traditional

82. A VaR system uses the estimated statistical properties of a portfolio's returns to estimate a maximum loss for a given time period and confidence level. For example, on average a bank should exceed a loss in excess of a 99% VaR 1 week in every 100. For an overview of VaR, see Aswath Damodaran, *Value at Risk: Where is the Beef?*, DAMODARAN ONLINE, <http://pages.stern.nyu.edu/~adamodar/pdfiles/papers/VAR.pdf> (last visited Mar. 25, 2012) (explaining VaR and related issues).

83. See, e.g., BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS 107–08 (2004), available at <http://www.bis.org/publ/bcbs128.pdf> (discussing use of VaR to calculate minimum capital charges for banks).

84. See *id.* at 38–40, 107–08; see also BASEL COMM. ON BANKING SUPERVISION, THE SUPERVISORY TREATMENT OF MARKET RISKS (1993), available at <http://www.bis.org/publ/bcbs11a.pdf> (discussing use of VaR in a variety of regulatory paradigms).

85. Frank Partnoy, *The Paradox of Credit Ratings*, in RATINGS, RATING AGENCIES, AND THE GLOBAL FINANCIAL SYSTEM 65 (Richard M. Levich et al. eds., 2002) [hereinafter Partnoy, *The Paradox of Credit Ratings*]; Frank F. Partnoy, *The Siskel and Ebert of Financial Markets: Two Thumbs Down for the Credit-Rating Agencies*, 77 WASH. U. L.Q. 619 (1999) (arguing that investors placed reliance on credit rating agencies not because of reputational capital but due to regulatory requirements). In support of this argument, Cantor et al. surveyed 200 pension plan sponsors and investment managers in the United States and Europe, and found that 75% face minimum rating requirements for their investments. Richard Cantor et al., *The Use of Credit Ratings*

role of ratings agencies as certifiers of quality was supplemented by a secondary role as regulatory gatekeeper.⁸⁶ The latter role undermined the importance of the first and, with it, the strength of the reputational incentives that ensured the accuracy of rating agency assessments. The codification of credit market regulation thus damaged the effective functioning of the tacit incentives that underpinned the market.

The second impact of regulatory codification relates to its effect upon bilateral tacit contracts between market players. Tacit contracts of this type abound in finance and in wider economic life. For example, it is widely believed that investment banks use tacit contracts with their investor networks to ensure that new issues are accurately priced, and that they are fully taken up by investors. An investor who gives false information about an issue's value, or who refuses to invest in an issue, finds itself excluded from future issues, and, hence from a reliable source of income.⁸⁷ Similarly, trades in diamond and cotton markets rest in large part upon trust and reputational sanctions,⁸⁸ and many day-to-day transactions in apparently quantifiable activities as manufacturing are founded upon reputation, trust, and repeated interaction.⁸⁹

Codified rules may reduce the number and the variety of tacit contracts possible between market players. One reason for this is that regulators may codify rules for market exchanges that, while detailed and enforceable, fail to account for all of the subtleties and nuances of real transactions. A rule may prevent deals from happening both in situations where they are desirable and undesirable. In the former case, a willing counterparty to a welfare-enhancing tacit understanding may later be able to overturn the agreement. Fear that this may occur will prevent the original tacit agreement from being reached, and the resultant benefits from being realized.

The codification of rules may also undermine tacit contracting by making it easier to find alternative contracting arrangements. When formal regulations improve to the level where they can support a transactional business arrangement, market participants can always fall back on the transactional arrangement if tacit contractual arrangements fail. The consequence is that traders have less to lose from a failure of tacit contractual arrangements and, as a result, they are less concerned about honoring such arrangements. The socially superior outcomes attainable via trust-based tacit contracting can therefore be crowded out by crude but enforceable formal rules.⁹⁰

in *Investment Management in the United States and Europe*, 17 J. FIXED INCOME 13 (2007).

86. Partnoy, *The Paradox of Credit Ratings*, *supra* note 85.

87. See, e.g., MORRISON & WILHELM, *supra* note 13, at 83–87 (discussing the extra-legal nature of investment banking); Lawrence M. Benveniste & Paul Spindt, *How Investment Bankers Determine the Offer Price and Allocation of New Issues*, 24 J. FIN. ECON. 343 (1989) (discussing the practices of investment banks in the allocation to clients of initial public offering shares); Lawrence M. Benveniste & William Wilhelm, Jr., *A Comparative Analysis of IPO Proceeds under Alternative Regulatory Regimes*, 28 J. FIN. ECON. 177 (1990) (discussing the impact of imperfect and faulty information on the behavior of investors and underwriters).

88. See Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992) [hereinafter Bernstein, *Opting Out*] (discussing the role of trust, reputation, and norms as a substitute for formal law in the diamond industry); Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Imminent Business Norms*, 144 U. PA. L. REV. 1765 (1996) [hereinafter Bernstein, *Merchant Law*] (discussing the role that non-legal sanctions may play in the motivations of merchant transactors).

89. See Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 63 (1963) (discussing the role of reputation and norms in business dealings among manufacturers).

90. For a more detailed discussion of this point, see MORRISON & WILHELM, *supra* note 13, at 57–58;

In designing investment bank regulations governing counterparty relationships, we therefore face a trade-off. On the one hand, more precise and codified rules can help to fix expectations, and they may facilitate valuable trade that would not have proceeded without the aid of the formal law. On the other hand, codified rules can crowd out tacit contracts.⁹¹ It is very hard in any specific case to say which of these effects dominates. However, in general, codified and formal regulation seems most likely to succeed in a market place that is dominated by arm's-length transactional trade of the type that we discussed in Part III. Reputational incentives are of least importance in such a market, and, moreover, traders in these markets rely to a greater extent upon bright-line law, so that more codified contract may broaden the contract space in these markets. It is because of the formality necessary in this bright-line law that legal standards like fiduciary duty with their inherent ambiguity are inappropriate.

In contrast, formal regulation is of least value in markets where the most important agreements are tacit, and so are not susceptible to codification. These markets are characterized by the trust-based trade described in Part III.B. Codified rules seem unlikely in these markets to expand the range of possible contracts in a useful way. At the same time, they serve to undermine the ability of market participants to resolve their conflicts through reputationally underpinned private arrangements. A more tacit, relationship-based legal standard like fiduciary duty may be more appropriate in this case.

How does the SEC's action against Goldman Sachs, as well as the need for any additional regulation, fit into this framework? Our analysis refers to two cases, one in which trade is largely arm's length and transactional, and another in which trade is trust-based and reputational. We argued in Part III.B that if the ABACUS deal were transactional, then there would be a case for codified rules. Such a case supports the SEC's application of federal securities laws to the transaction, but not in the fiduciary duty-like manner the SEC purported to apply. As we theorized in Part III, additional formal codified law appears not only unnecessary but economically inefficient and contrary to parties' norms and expectations.

Suppose, on the other hand, that the deal could be characterized as trust-based. We have argued that, beyond a framework that gives the parties recourse against theft and outright misrepresentation, codified rules have little to offer in this situation.⁹² On the contrary, any attempt to write detailed formal rules governing the relationship between parties engaged in trust-based contract is likely to undermine their relationship and crowd out their own superior contracting relationships. In short, unless the SEC expected to prove that Goldman Sachs lied to or stole from its counterparties, it is unclear that its

Bernstein, *Opting Out*, *supra* note 88; Bernstein, *Merchant Law*, *supra* note 88; George Baker et al., *Subjective Performance Measures in Optimal Incentive Contracts*, 109 Q.J. ECON. 1125 (1994); George Baker et al., *Relational Contracts and the Theory of the Firm*, 117 Q.J. ECON. 39 (1994).

91. Data suggesting that such crowding out may have occurred is presented in Oliver Faltn-Traeger & Christopher Mayer, *Lemons and CDOs: Was Goldman Sachs Alone in Issuing Poorly Performing CDOs* (May 10, 2010) (unpublished manuscript), available at <http://www1.gsb.columbia.edu/mygsb/faculty/research/pubfiles/4667/Goldman%20Sachs%20CDOs%20Mayer.pdf>. The authors show that the ABACUS reference portfolio assets "suffer[ed] considerably lower downgrade severity than the average CDO deal" and report that assets underlying the CDOs sponsored by investment banks suffered fewer downgrades than those sponsored by more highly regulated domestic and foreign commercial banks. *Id.* at 6, 28.

92. See Part III.B.

action could have accomplished a great deal, and additional regulation is similarly fruitless.

But what about fiduciary duties and the imposition of this ambiguous, gap-filling substitute for trust and reputation? There are circumstances where imposition of this legal standard can effectively substitute for a trust-based relationship and produce economically superior outcomes.⁹³ Such circumstances arise in the context of this Article when there are well-established standards and norms of behavior, so that a third-party arbiter is able to judge whether parties have adhered to such standards. In addition, one or both of two conditions must exist: first, one of the parties to the trade must lack either the sophistication or the resources needed to identify violations of the received norms of behavior; second, one of the parties to the trade must be unable to credibly threaten to impose reputational sanctions upon the other, either because it lacks market voice or market credibility. These circumstances conceivably arise when investment banks serve retail clients as investment advisors, and, in fact, such fiduciary-type standards are currently imposed.⁹⁴ There is evidence that some of their potency derives simply from the ability of the regulatory supervisor to credibly indicate to the market that a reputational sanction is appropriate.⁹⁵

This Article focuses on the relationships of investment banks with sophisticated counterparties.⁹⁶ However, based on our analysis, we preliminarily believe that the issue of fiduciary duties as applied to broker-dealers in their interactions with retail customers requires further study to determine if and how our criteria for imposition of a fiduciary duty standard is met. In particular, the same types of difficulties in identifying transactional versus trust-based interactions arise in this context, such that, even if fiduciary duties are appropriate, they may not be economically efficient if applied on a uniform basis.⁹⁷

We believe that imposition of a fiduciary duties standard when investment banks are dealing with commercially sophisticated parties, such as in the ABACUS transaction, would be inappropriate for a number of reasons. First, such a standard could result in a judicially imposed codification that would serve to undermine tacit contracting by formalizing banks' fiduciary duties. This would impose a soft type of codification to the same deleterious effect. Second, such a standard is likely to be inefficient in a sophisticated market where parties can represent themselves and, if reputation is perceived as an insufficient substitute, contractually negotiate bespoke standards. This is particularly true since deviations from market norms are likely to be rare and thus the

93. For an alternative view of the regulation of investment bank conflicts of interest, one based on the information economizing role of investment banks, see Andrew F. Tuch, *Conflicted Gatekeepers: The Volcker Rule and Goldman Sachs* (Harvard John M. Olin Ctr. for Law, Econ., and Bus., Fellows' Discussion Paper No. 37, 2011), available at <http://ssrn.com/abstract=1809271>.

94. SEC BROKER STUDY, *supra* note 17, at iii–iv.

95. See John Armour et al., *Regulatory Sanctions and Reputational Damage in Financial Markets 1* (Oxford Legal Studies Research Paper No. 62/2010, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1678028 (presenting evidence that the stock price reaction to regulatory sanctions on the London Stock Exchange is on average almost nine times larger than the financial penalty imposed).

96. In this capacity investment banks are serving as broker-dealers.

97. See SEC BROKER STUDY, *supra* note 17, at 93–101 (asserting that retail investors have differing perceptions concerning the obligations of broker-dealers).

need for default standards to improve efficiency is absent.⁹⁸

Finally, and we believe most importantly, in this type of trade it is quite difficult to determine the beliefs and the incentives of the deal parties, and, hence a failure on an investment banks' part to abide by the reasonable expectations of its counterparties as set by market norms.⁹⁹ It is precisely because this sort of determination is quite difficult that trust-based contracting remains important in finance. As a result, the SEC's application of the anti-fraud rules in a fiduciary-like manner to this transaction was economically wealth-destroying to the extent it purported to regulate a trust-based relationship.

VI. CONCLUSION

Computerization has transformed investment banking. Better information processing, more precise codification of data, and advances in financial economics have all served to shift an increasing proportion of the business of large investment banks into their dealing rooms. Within their dealing rooms, investment banks rely upon a transactional, arm's-length model of business, so that they need a reputation for competence and transparency, but not for their ability to sustain private, trust-based trade. This Article illustrated that these technological and economic imperatives have changed investment bank culture, with reference to Goldman Sachs, a bank that has long been associated with a focus upon client relationships.

Regulators have responded to the changes within banks by relying to an increasing extent upon codified data, frequently generated by bank-level computer systems. While these systems represent an important source of information, and hence have an important role to play in regulation, they must be deployed appropriately. Better data and codified law make it easier to write arm's length contracts to improve trading conditions in transactional markets. But an attempt to use codified law in place of tacit information to regulate investment bank counterparty relationships that are largely dependent upon reputation and trust-based contracting is likely to alter the ways in which these markets operate. In particular, it may crowd out the tacit contracting upon which these markets rely.

The SEC's charge against Goldman Sachs' behavior with respect to its ABACUS transaction was particularly interesting in light of these observations. If the SEC had proved that Goldman Sachs misrepresented the facts of this transaction to its counterparties then, clearly, Goldman Sachs would have had a case to answer. But it is difficult to see how one could go much further than this.

Our analysis indicates that the central question for authorities contemplating further regulation of investment banks and their counterparty interactions is whether a given deal was largely governed by arm's-length transactional business norms, or whether it was an example of the trust-based contract that predominated in investment banking 30 years

98. For an interesting view which partly coincides with our transactional approach, see Thompson, *supra* note 11, at 329. Thompson argues that regulation should focus on whether the investment bank intermediary is receiving compensation which destroys its indifference to the outcome of the transaction. *Id.*

99. We believe that the economic view of fiduciary duties put forth by Easterbrook and Fischel is the appropriate vehicle to analyze the imposition of fiduciary duties in this context. See EASTERBROOK & FISCHEL, *supra* note 11, at 90–93. Nonetheless, even on a trust-based or other core notion of fiduciary duties we would be hesitant to impose this standard for the reasons we specify.

ago. If the ABACUS transaction fell into the former category, then the case appears rather weak for imposition of any additional regulation.

If the ABACUS transaction relies upon trust-based contracting, then we have argued that formal codified law has little to offer and standards such as fiduciary duty are likewise inefficient; the latter may particularly crowd out more efficient reputational trade. If the Senate hearings were a prelude to regulation of the conduct of trust-based business among these sophisticated parties, particularly the imposition of fiduciary duties, then given the state of the market they are likely to reduce the volume of such trade. It is possible that the violent market reaction to the SEC's complaint was in anticipation of this.¹⁰⁰ The SEC's case was ultimately illustrative of the shifting sands of the investment bank counterparty relationship from trust-based to transactionally-oriented. If nothing else, it motivated introspection within the investment-banking community of the sort found in Goldman Sachs' January 2011 business standards report.¹⁰¹ In large part, the report focused on the tensions identified in this Article arising from Goldman Sachs' various intermediary functions with special emphasis given to the firm's structured products business.¹⁰² Although the report emphasizes its recommendations as representing a re-commitment to clients and to "reputational excellence," the economic framework developed in this Article suggests that such commitments will be difficult to sustain in large, full-service banks as they increasingly turn to transactional trade.¹⁰³ But while the market may be shifting, the case for heightened regulation of sophisticated, institutional client relationships on economic efficiency grounds appears yet to be substantiated.

100. We do not presume that imposition of fiduciary duties would ever be inappropriate, just that in this case under current investment banking practices, they would be. Circumstances may change which justify imposition of such duties based on the criteria we have set forth.

101. For more information on Goldman's creation of a Business Standards Committee, see Lloyd Blankfein, Opening Statement at the Goldman Sachs 2010 Annual Meeting of Shareholders (May 7, 2010), available at <http://www2.goldmansachs.com/media-relations/comments-and-responses/archive/lcb-annual-meeting.html>.

102. See GOLDMAN SACHS, REPORT OF THE BUSINESS STANDARDS COMMITTEE (2011), available at <http://www2.goldmansachs.com/who-we-are/business-standards/committee-report/business-standards-committee-report-pdf.pdf>.

103. See Press Release, Goldman Sachs Grp., Inc., Goldman Sachs Announces Publication of Business Standards Committee Report (Jan. 11, 2011), available at <http://www2.goldmansachs.com/media-relations/press-releases/archived/2011/bsc-rep.html>.

Figure 1: The ABACUS transaction


