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# A Difficult Path in Goldman Case

**By BINYAMIN APPELBAUM**

WASHINGTON — In accusing Goldman Sachs of defrauding investors, regulators are not only taking aim at a company with deep pockets and a will to fight — they are also pursuing an unusual claim that could be difficult to prove in court, legal experts said.

Rather than asserting that Goldman misrepresented a product it was selling, the most commonly used grounds for securities fraud, the Securities and Exchange Commission said in a civil suit filed Friday that the investment bank misled customers about how that product was created.

It is the rough equivalent of asserting that an antiques dealer lied about the provenance, but not the quality, of an old table.

To a layperson, the case against Goldman may seem clear cut.

After all, investors did not know some information about the product that they might have considered vital, and they lost $1 billion in the end. But the rules that govern these kinds of transactions are not so plain.

Several experts on securities law said fraud cases like this one, which focuses on context rather than content, are generally more difficult to win, because it can be hard to persuade a jury that the missing information might have led buyers to walk away.

They added, however, that the strength of the S.E.C.'s case is impossible to gauge until the agency discloses more of the evidence it has assembled. So far it has provided only a sketch.

The stakes are huge. The S.E.C., battered by its failure to identify or prevent several major frauds in recent years, is eager to re-establish its credibility as an enforcer. But in choosing such a difficult battlefield, the commission also risks losing a case at a time when it is trying to re-establish its reputation as a tough watchdog.

Goldman’s sterling reputation, a foundation of its financial success, is also on the line. Rather than settling with the government, it has so far chosen to fight back. The company says it provided its investors with all the information required by law. It has also stressed that it sold the securities to financial firms that were sophisticated investors.

The commission’s core accusation is that while Goldman provided to those firms a detailed list of the assets contained in a security it built and sold in 2007, it concealed the role of John Paulson, a hedge fund manager who worked with Goldman to pick what assets went into the security. Mr. Paulson then placed bets that the security would lose value.

In essence, the buyers bet that housing prices would go up, while Mr. Paulson bet that prices would fall.

Goldman was not legally required to provide any information to the investors, because Goldman found the buyers without offering them on the open market. But for any information that Goldman chose to provide, it was required by law to give a complete and accurate account.

Goldman outlined its likely defense arguments in two letters sent to the S.E.C. in September in response to a notice from the agency that the company was under investigation and could be sued.

In the letters, Goldman’s lawyers at Sullivan & Cromwell wrote that the company Goldman hired to manage the deal, ACA Management, was “no mindless dupe that could be easily manipulated.” Furthermore, the letters said that the downturn of the housing market was not a foregone conclusion, and that it was therefore misleading for the S.E.C. to consider the transaction through the lens of “perfect hindsight.”

The letters went on to argue that, contrary to the S.E.C.’s assertions, Goldman disclosed all information about the deal that was material. In particular, the letters drew a sharp distinction between information about the security, which the company said it provided in full, and information about Mr. Paulson’s role.

The second letter said, “It is this concrete information on the assets — not the economic interest of the entity that selected them — that investors could analyze and use to inform their decisions.”

To win its case, the S.E.C. must prove that Goldman was not merely silent about Mr. Paulson's role but actually gave investors the wrong impression, experts in securities law said. Then it must prove that the missing information was material, a legal term meaning that investors armed with that knowledge might have decided not to buy the product from Goldman, or to do so at a lower price.

Allen Ferrell, a law professor at Harvard, said the suit rested on an unusual definition of material information.

"We normally think of material information as specific to the mortgages, not somebody's prediction about the future course of macroeconomic events," Professor Ferrell said. "So who cares whether Paulson is bullish or bearish? Whatever his personal opinion is about the future course of housing prices, the question is, did the investors have access to the underlying mortgages?"

But Donald C. Langevoort, a law professor at Georgetown University, said the case was consistent with other government efforts in past years to broaden the definition of material information. "The S.E.C. has long insisted that context is important," Professor Langevoort said. "If you think of it more broadly in that way, this isn't an unprecedented case."

Professor Langevoort cited as an example the commission's 2003 settlement with 10 investment banks over accusations that their research departments were providing recommendations to investors without disclosing that favorable reviews were used to attract underwriting business from the companies issuing the stock.

Adam C. Pritchard, a law professor at the University of Michigan, said that the S.E.C.'s focus on the construction of Goldman's security reflected the increased complexity of financial instruments. Construction has simply become a more important part of the process, he said. But he added, "The basic idea that an undisclosed conflict of interest could be misleading is pretty much as old as stockbrokers."

In pursuing a new twist on an old idea, however, the S.E.C. has deeply unsettled the financial markets, opening the way for investors to file claims against banks that sold similar products, and forcing firms to reconsider their own liability.

Richard W. Painter, a corporate law professor at the University of Minnesota, said the novel nature of the fraud charges made it important for the S.E.C. to disclose more details quickly, so that markets were not paralyzed by uncertainty over the boundaries.

“The S.E.C. needs to step to the plate with very specific facts and make it clear what they think Goldman did that was wrong,” Professor Painter said.

*Andrew Martin and Michael J. de la Merced contributed reporting from New York.*