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Goldman's 'punishment': Two weeks' earnings

$550 million penalty may be a record, but the Wall Street firm got off light, say experts

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Goldman Sachs Group Inc.'s $550 million settlement with U.S. regulators yesterday will benefit the firm by ending three months of uncertainty at an affordable price. Now the rest of Wall Street begins calculating the cost.

Investors welcomed the deal with the Securities and Exchange Commission, saying the company won key points: The cost was below some analysts' estimates of at least $1 billion; no management changes were required; and Goldman Sachs said the SEC indicated it doesn't plan claims related to other mortgage- linked securities it examined. The stock's late surge on anticipation of a settlement yesterday added more than $3 billion to the company's market value, and it climbed further after New York trading closed.

“You'd have to look at it as a victory for Goldman,” said Peter Sorrentino, senior portfolio manager at Huntington Asset Advisors in Cincinnati, which manages $13.3 billion including Goldman Sachs shares. “This takes a cloud off the stock.”

In the settlement, unveiled less than two hours after the Senate passed legislation to reform the financial system and avert future crises, Goldman Sachs acknowledged that marketing materials for the 2007 deal at the center of the case contained “incomplete information.” In its April 16 suit, the SEC accused the firm of defrauding investors in a mortgage-backed collateralized debt obligation by failing to tell them that hedge fund Paulson & Co., which was planning to bet against the deal, had helped to design it.

‘One of the Worst Days'

In its original public response, Goldman Sachs had called the SEC's case “unfounded in law and fact” and maintained that it made all disclosures about the CDOs that should be material to the “sophisticated” investors who lost money on the deal. Chairman and Chief Executive Officer Lloyd Blankfein, who said the day the suit was filed was “one of the worst days in my professional life,” said in May that the bank established a committee to review the firm's business standards.

The settlement requires the New York-based company to increase training for employees who structure or market mortgage securities, and to bolster the vetting and approval process. Those changes will probably lead to a new industry standard for disclosures in private sales of securities, even to the most sophisticated investors, analysts said.

“All of the firms are going to adjust their internal standards for this,” Brad Hintz, an analyst at Sanford C. Bernstein & Co. in New York, said in an interview. The agreement means “a private placement doesn't absolve you from the accuracy of the disclosure and you'd better have very, very good compliance watching what your sales people are saying.”

‘Best Practices'

Robert Khuzami, the SEC's director of enforcement, said at a news conference yesterday that his agency means to send a signal to the entire industry.

“We would strongly encourage other institutions to adopt any kinds of best practices that they see across the street in order to prevent this kind of wrongdoing,” said Khuzami, 53. “The deterrence, and preventing a fraud before it occurs, is a much better outcome than picking up the pieces afterwards.”

The SEC is still investigating other companies and a range of products that fueled losses during the financial crisis, Khuzami said. Last month, the agency sued New York-based ICP Asset Management LLC on claims that it improperly traded assets in CDOs it managed. ICP has denied wrongdoing.

Goldman Sachs said in a statement that the SEC doesn't plan to target the firm over any other products that the agency has reviewed.

Case Against Tourre

“We understand that the SEC staff also has completed a review of a number of other Goldman Sachs mortgage-related CDO transactions and does not anticipate recommending any claims against Goldman Sachs or any of its employees,” the firm said.

The SEC's case continues against Fabrice Tourre, the only Goldman Sachs employee the agency sued over the CDO. Tourre, 31, is due to respond to the complaint by July 19. He told a Senate subcommittee in April that he “categorically” denies the SEC's allegations and will fight them in court.

The SEC's deputy enforcement director, Lorin Reisner, said Goldman Sachs agreed to cooperate in the case against Tourre, who is on leave and whose legal expenses are being paid by the company. Tourre's attorney, Pamela Chepiga at Allen & Overy LLP, didn't reply to an e-mail and phone message.

Blankfein, 55, and the firm's other senior managers may not emerge from the SEC case unscathed, even if they weren't forced to resign.

‘Repair Their Reputation'

“Within a decent interval, you're probably going to see a new CEO,” said Christopher Whalen, a New York Federal Reserve official in the 1980s and co-founder of Institutional Risk Analytics, in an interview on Bloomberg Television. “They still have a lot of work to do with clients and may face claims and litigation going forward, and they have to repair their reputation.”

William Cohan, an author and former investment banker who is writing a book about Goldman Sachs, said that Blankfein's position is secure for the “foreseeable future.” Cohan expects the next CEO will come from an investment banking background rather than trading, the business drawing regulators' scrutiny.

“I will predict that this is the last trading-oriented CEO of Goldman Sachs for a while,” Cohan said in an interview with Bloomberg Television.

SEC Chairman Mary Schapiro, 55, has previously denied speculation that the lawsuit was filed to support financial-reform legislation backed by President Barack Obama by casting Goldman Sachs, the most profitable securities firm in Wall Street history, as a villain. There was “absolutely no consideration” to the bill, Khuzami told reporters, hours after the bill cleared the Senate. Still, the timing raised some eyebrows.

‘Highly Suspicious'

“It is highly suspicious, and it makes the SEC now look like it is totally politicized,” said Paul Atkins, a former Republican SEC commissioner who is now a financial services consultant.

While the SEC touted the $550 million settlement as the largest it ever levied against a Wall Street firm, it fell short of some analysts' estimates for a $1 billion fine. Hintz, who estimated the agreement will shave 93 cents from the firm's earnings, said he had predicted it would cost $1.05 per share.

For Goldman Sachs, the cost represents about 14 days' worth of earnings, based on first-quarter profit. Blankfein, who was awarded a record-setting $67.9 million bonus for 2007, has stock in the firm that's worth almost $490 million, based on the firm's last proxy statement.

Shares Gain

The SEC's disclosure yesterday that it planned a “significant announcement” fueled speculation that a deal was imminent, sending the firm's shares up 4.4 percent to $145.22 at the end of New York Stock Exchange composite trading. The stock, which had lost more than 20 percent since the suit was filed, is likely to rise further, said Hintz.

“I'm jumping up and down and telling my dad to buy it,” Hintz said of Goldman Sachs's stock.

Bank of America Merrill Lynch said it upgraded its rating on Goldman Sachs to “buy” in a note to clients following the agreement yesterday.

The settlement is “palatable” and the “probability of further action against Goldman Sachs” is much lower, said analysts led by New York-based Guy Moszkowski in the note.