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In Clearing Bayou, Quagmire for Goldman

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"Did Sam Israel come to the dinner? Has Bayou ramped it up yet?" asked a top **Goldman Sachs** executive in a 2004 e-mail.

The executive, Duncan L. Niederauer, now head of the New York Stock Exchange, was writing to make sure that Goldman would keep the business of Samuel Israel III, whose hedge fund, the **Bayou Group**, was paying the firm often millions of dollars in fees a year to clear its trades.

The next year, Bayou collapsed amid fraud investigations. Mr. Israel would later be convicted of defrauding investors of hundreds of millions of dollars and was sentenced to 22 years in prison.

Bayou's unsecured creditors filed an arbitration contending that Goldman knew for several years that the Connecticut hedge fund was hemorrhaging money even when it was claiming impressive returns.

Now, newly unsealed court documents — including Goldman e-mail and internal reports — portray a firm that at times seemed to turn a blind eye to its own internal concerns about Bayou as it raked in fees from the hedge fund.

During the arbitration, Goldman denied allegations it had ignored signs of wrongdoing. "We have asked the court to review the arbitration panel's decision and believe it is inappropriate to comment."

Through a spokesman, Mr. Niederauer declined to comment.

The documents — providing a rare window into a Wall Street firm's clearing of a hedge fund client — have come to light as a result of litigation involving the unsecured creditors, who have accused Goldman of ignoring signs that the hedge fund was a Ponzi scheme.

In July, Goldman moved to vacate the decision ordering it to pay $20.6 million, the largest investor arbitration award ever levied against the Wall Street firm.

The award was a watershed. If the federal courts uphold the arbitration decision, it could have ramifications across Wall Street. Wall Street firms, which handled billions of dollars

in trades, say that their job is to clear the trade, not police the clients.

If the Bayou arbitration award is upheld, Wall Street's main lobby group, the Securities Industry and Financial Markets Association, has argued it could paralyze trading.

Goldman has its work cut out for it in its move to have the award thrown out. Arbitration awards are rarely overturned by courts and can be vacated only on a handful of grounds: for bias, fraud or if courts find there was "manifest disregard" of the law in the arbitration process.

The award and the unsealed documents could complicate the industry's position. They show Goldman's clearing division had at times serious concerns about Bayou, yet failed to alert securities regulators, raising fresh questions about what the obligations of a clearing firm should be.

"Do we care if the Bayou 'Bayou No Leverage Fund' uses leverage?" asked a Goldman Sachs executive, Charles Sweeney, in a December 2003 e-mail to two colleagues. Mr. Sweeney, through the Goldman spokesman, declined to comment. A Goldman spokesman said that Bayou's new account form allowed it to use margin.

Bayou had $89 million in trading losses while a Goldman client, documents show. Those losses translated into big business for Goldman. The firm made $9.5 million from Bayou from 1999 to 2005.

While that is a drop in the bucket for Goldman, which posted a profit of $13.4 billion in 2009, it is significant for the firm's clearing division. At one point Bayou was a "top 50 clearing client" of Goldman and accounted for 1 percent of all the revenue made by the clearing division, documents show.

Court exhibits and e-mails indicate the firm knew of Bayou's claims of lofty returns. However, Goldman executives testified during arbitration that they were not aware of Bayou's assertions of lofty returns.

Goldman's clearing manual contains a warning to employees about hedge funds, documents show. "If I were going to launder money, I'd use a hedge fund," wrote Jon S. Corzine, a former Goldman chief executive and now head of the brokerage firm MF Global. "It's a good way to move large sums of money. There is no supervision, and you don't have to reveal who your clients are."

Trading records show Bayou made many large wire transfers, often on the same day. For instance, on Dec. 21, 2004, $1.6 million was wired into Bayou's no-leverage fund from an account at Wachovia. That same day, five wires went out of the fund for the same amount. The amount came in from one source, and went out to five different ones.

This practice is known as flipping and is suspicious because it could indicate a fund was

laundering money. A Goldman spokesman declined to comment, referring instead to testimony by its executives that says its clearing division does not monitor this sort of activity.

Separately, in 2003, Bayou set up four hedge funds for investors, including the no-leverage fund. Goldman executives, however, spotted some funds had similar trading strategies. “Bayou has multiple funds and they tend to all do similar trades,” Mr. Sweeney said in an e-mail in May 2003.

A Goldman spokesman declined to comment, pointing instead to testimony during arbitration where an expert hired by Goldman said that similar strategies in different funds were not uncommon.

Hedge funds often clear through multiple brokerage firms, so losses in one account may not be indicative of the fund’s actual performance. Still, documents show Goldman and Bayou Securities, the hedge fund’s broker-dealer, had an exclusive clearing agreement, which the claimants argued showed Bayou should have been clearing only through Goldman.

A Goldman manager, Kyle Czepiel, told regulators in 2004 during a separate investigation into Bayou’s operations that “the hedge funds never traded away from Bayou Securities,” and Goldman “was the only clearing firm through whom they traded.” During the Bayou arbitration he said that Bayou “might” have traded a few products away from Goldman. Goldman declined to comment.

During the arbitration, the unsecured creditors argued that bankruptcy case law showed that Goldman should be held liable for the losses. One case, Gredd v. Bear Stearns, found that once a clearinghouse was on “inquiry notice” about a possible fraud, meaning it knew or should have known a fraud might have been taking place, it had a responsibility to make a good faith investigation of the suspicious activity.

In the Gredd case, a Bear Stearns executive heard at a party that the Manhattan Investment Fund was reporting big returns to clients. But the executive knew that the fund’s account at Bear was losing money. Eventually Bear notified regulators of the concerns. A jury found Bear should not be held liable for the losses in the fund.

The Gredd case, however, found that to be held liable a clearinghouse has to do more than simply hold the money; it has to exercise some type of control over it. For instance, there may be a margin account, where the clearinghouse has a legal right to access the funds.

“The firm has to do more than simply carry the funds in the customer’s accounts, it has to exercise some discretionary power over the money,” said Henry Minnerop of the law firm Sidley Austin, who wrote a brief in support of Goldman’s motion to vacate the Bayou

award.

John G. Rich, a lawyer for the unsecured creditors and a partner at the law firm Rich & Intelisano, said Goldman had the ability to use the funds for its own purpose, and was on inquiry notice about fraud at Bayou, yet did nothing.

“Despite facts showing potential fraud was taking place they put their head in the sand and continued to collect significant commissions from Bayou,” Mr. Rich said.

The Manhattan Fund is different from Bayou in that it constantly had margin debt in its account. Goldman has argued that because Bayou did not have margin debt on the days it was transferring money, Goldman was a mere conduit of the funds and the unsecured creditor’s case was baseless.

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