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S.E.C. Puts Wall St. on Notice

By EDWARD WYATT

WASHINGTON — In the last few years, the Securities and Exchange Commission seemed like the cop in the doughnut shop, sitting idly by while the likes of Lehman Brothers and Bernard L. Madoff ran amok.

But with its latest lawsuit against Goldman Sachs, the most powerful, most feared and most envied firm on Wall Street, the S.E.C. is sending a signal that it is back on the beat and that it is going after very big targets.

In interviews this weekend, Mary L. Schapiro, the commission's chairwoman, and Robert Khuzami, its new director of enforcement, said the agency was stepping up both its rule-making and its investigations in the wake of the financial crisis.

Neither would elaborate on the case being pursued against Goldman, but Ms. Schapiro said the commission had recently proposed new rules for credit rating agencies and for the reporting of the specific investments behind asset-backed securities, two issues that were integral to the recent financial crisis.

The Goldman case is not the only example of the agency raising its sights. Last week, General Electric said the S.E.C. had asked for information about reassurances that its chief executive, Jeffrey R. Immelt, made in 2008 about the company's ability to refinance its debt.

In his recent memoir, Henry M. Paulson Jr., the former Treasury secretary, said Mr. Immelt told him at the time that G.E. was having problems selling short-term debt. G.E. said on Friday that it was cooperating with the agency and that its disclosures were accurate.

The S.E.C. also has joined an international investigation into whether Hewlett-Packard paid bribes to win business in Russia. The company said it was cooperating with investigators while conducting its own inquiry.

"We're seeing a resolve in the enforcement division that was lacking a year and a half or two years ago, and even 10 years ago," said James D. Cox, a Duke University law professor. "Americans should take heart" in the Goldman case, he said.

Ms. Schapiro, who took over as S.E.C. chairwoman last year, has vowed to reinvigorate the agency.

"I think everybody a few years ago got caught up in the idea that the markets are self-correcting and self-disciplined, and that the people in Wall Street will do a better job protecting the financial system than the regulators would," she said. "I do think the S.E.C. got diverted by that philosophy."

The S.E.C. has adopted an unusually aggressive posture with Goldman Sachs. Though it informed the company in the middle of last year that it might face charges, Goldman did not know until the news was already out on Friday that the S.E.C. had filed a civil fraud lawsuit, according to people on both sides of the issue who spoke on the condition of anonymity because they were not authorized to discuss the case. Goldman was not given the chance to discuss a settlement or prepare for the announcement, a departure from common practice.

In the long run, the agency's reputation will rest more on whether it can win its case against Goldman than on its aggressive tone.

The S.E.C. charged last week that Goldman had created and sold a mortgage investment that was secretly intended to fail. Goldman said the charges were "completely unfounded in law and fact," and that it would "vigorously contest them and defend the firm and its reputation." Goldman said that it lost money on the transactions at issue.

Goldman has already provided answers to some of the S.E.C.'s questions. In the fall Goldman responded to a Wells notice from the S.E.C., producing two hefty filings — a 40-page response on Sept. 10 and a 16-page response on Sept. 25. In those filings, Goldman said it was common practice for banks to devise synthetic C.D.O.'s — collateralized debt obligations, which are a bundle of mortgage bonds — to suit an investor. Goldman cited other mortgage bundles that other banks created in partnership with hedge funds, where the hedge fund's role was not disclosed.

Regarding the S.E.C.'S allegation of fraud in a specific Abacus deal by Goldman that was created at the request of the hedge fund Paulson & Company, in which Paulson helped select the toxic securities that went into that deal, Goldman said, "the non-disclosure of Paulson's role (and its separate hedge in transaction with Goldman Sachs) simply reflected industry practice not to disclose client names." Indeed, it added later that firms had an ethical "obligation not to divulge client information."

Not all of the S.E.C.'s recent actions have been winners. Last August, a federal judge in New York slapped down a proposed $33 million settlement with Bank of America over accusations that it had failed to adequately disclose to shareholders details of the financial condition of Merrill Lynch as the two were merging. More than six months later, the judge reluctantly approved a $150 million settlement, but he complained that it was an insufficient penalty.

And the commission has been the subject of three scathing investigative reports over its failure to catch irregularities in some of the biggest investment debacles in history, including those involving Lehman Brothers and Bernard L. Madoff Investment Securities. It had even received tips years ago that Mr. Madoff was running a Ponzi scheme but failed to develop a case against him.

On Friday, the S.E.C. inspector general faulted the commission for failing to uncover a possible $7 billion Ponzi scheme at the Stanford Financial Group. Although its examiners had discovered evidence of wrongdoing in 2002, the district enforcement division did not take action, the inspector general said.

Ms. Schapiro said in an interview over the weekend that the S.E.C. shortcomings noted in the recent reports had been addressed in part by the makeover of the enforcement division.

Mr. Khuzami, the new enforcement director, said one of the most important changes was eliminating a rule that required investigators to get majority approval of the five-person commission in order to issue subpoenas, which has allowed the division to move more quickly.

Marcel Kahan, a law professor at New York University, said the risk to Goldman's reputation was greater than its legal exposure. For instance, he said that Goldman's stock dropped nearly 13 percent on Friday, causing a greater loss in market capitalization than the worst imaginable S.E.C. fine.

"I think the negative P.R. for Goldman is a multiple of the legal one," he said. "It's very bad for business. You don't want to get the impression with your client that you are doing shady things."

As a consequence, Professor Kahan said, Goldman had no incentive to settle the case and would hire the nation's best lawyers to try to clear its name. Similarly, he said the S.E.C. had as much or more to lose, given its record in the last decade.

But just taking on Goldman Sachs is a sign the agency is more certain of its role as a tough watchdog for the markets, said Donald C. Langevoort, a law professor at Georgetown University who formerly worked in the office of the agency's general counsel.

"The S.E.C. has long lacked the kind of resources that would give them the confidence that they could take on a Goldman Sachs," he said, "because if Goldman Sachs decides to litigate, you know it's going to be a war."

Andrew Martin contributed reporting from New York.