

Bloomberg

How Paulson Gave Hedge Funds Advance Word of Fannie Mae Rescue

By Richard Teitelbaum - Nov 29, 2011
Bloomberg Markets Magazine

Treasury Secretary [Henry Paulson](#) stepped off the elevator into the Third Avenue offices of hedge fund Eton Park Capital Management LP in Manhattan. It was July 21, 2008, and market fears were mounting. Four months earlier, Bear Stearns Cos. had sold itself for just \$10 a share to [JPMorgan Chase & Co. \(JPM\)](#)

Now, amid tumbling [home prices](#) and near-record foreclosures, attention was focused on a new source of contagion: [Fannie Mae \(FNMA\)](#) and Freddie Mac, which together had more than \$5 trillion in mortgage-backed securities and other debt outstanding, Bloomberg Markets reports in its January issue.

Paulson had been pushing a plan in Congress to open lines of credit to the two struggling firms and to grant authority for the Treasury Department to buy equity in them. Yet he had told reporters on July 13 that the firms must remain shareholder owned and had testified at a Senate hearing two days later that giving the government new power to intervene made actual intervention improbable.

“If you have a bazooka, and people know you have it, you’re not likely to take it out,” he said.

On the morning of July 21, before the Eton Park meeting, Paulson had spoken to [New York Times](#) reporters and editors, according to his Treasury Department schedule. A Times article the next day said the Federal Reserve and the Office of the Comptroller of the Currency were inspecting Fannie and Freddie’s books and cited Paulson as saying he expected their examination would give a signal of confidence to the markets.

A Different Message

At the Eton Park meeting, he sent a different message, according to a fund manager who attended. Over sandwiches and pasta salad, he delivered that information to a group of men capable of profiting from any disclosure.

Around the conference room table were a dozen or so hedge- fund managers and other Wall Street executives -- at least five of them alumni of [Goldman Sachs Group Inc. \(GS\)](#), of which Paulson was chief executive officer and chairman from 1999 to 2006. In addition to Eton Park founder [Eric Mindich](#), they included such boldface names as Lone Pine Capital LLC founder Stephen Mandel, [Dinakar Singh](#) of TPG-Axon Capital Management LP and Daniel Och of Och-Ziff Capital Management Group LLC.

After a perfunctory discussion of the market turmoil, the fund manager says, the discussion turned to [Fannie Mae](#) and Freddie Mac. Paulson said he had erred by not punishing Bear Stearns shareholders more severely. The secretary, then 62, went on to describe a possible scenario for placing Fannie and Freddie into “conservatorship” -- a government seizure designed to allow the firms to continue operations despite heavy losses in the mortgage markets.

Stock Wipeout

Paulson explained that under this scenario, the common stock of the two government-sponsored enterprises, or GSEs, would be effectively wiped out. So too would the various classes of preferred stock, he said.

The fund manager says he was shocked that Paulson would furnish such specific information -- to his mind, leaving little doubt that the Treasury Department would carry out the plan. The managers attending the meeting were thus given a choice opportunity to trade on that information.

There’s no evidence that they did so after the meeting; tracking firm-specific short stock sales isn’t possible using public documents.

And law professors say that Paulson himself broke no law by disclosing what amounted to inside information.

Rampant Rumors

At the time, rumors about Fannie and Freddie were tearing through the markets. The government-chartered firms’ mandate, which continues today, is to buy mortgages from banks and repackage them into securities either for their own portfolios or to sell to others. The banks can then use the proceeds from those transactions to write new mortgages.

By mid-2008, delinquencies and foreclosures were soaring, and the GSEs set aside billions of dollars against future losses. In the first six months of 2008, they racked up net losses of \$5.46 billion as they slashed dividends and marked down the values of their huge inventories of mortgage-backed securities.

On Wall Street, confusion reigned. UBS AG analyst Eric Wasserstrom on July 10 cut his share price target on Freddie to \$10 from \$28. The next day, [Citigroup Inc. \(C\)](#) analyst Bradley Ball reiterated a “buy” recommendation on the two GSEs. On July 12, the Times of [London](#), without citing a source, reported that Paulson was contemplating a \$15 billion capital injection into the firms.

Shares Rally

At the time Paulson privately addressed the fund managers at Eton Park, he had given the market some positive signals -- and the GSEs’ shares were rallying, with Fannie Mae’s nearly doubling in four days.

William Black, associate professor of economics and law at the University of Missouri-Kansas City,

can't understand why Paulson felt impelled to share the Treasury Department's plan with the fund managers.

"You just never ever do that as a government regulator -- transmit nonpublic market information to market participants," says Black, who's a former general counsel at the Federal Home Loan Bank of [San Francisco](#). "There were no legitimate reasons for those disclosures."

[Janet Tavakoli](#), founder of Chicago-based financial consulting firm Tavakoli Structured Finance Inc., says the meeting fits a pattern.

"What is this but crony capitalism?" she asks. "Most people have had their fill of it."

A Lawyer's Advice

The fund manager who described the meeting left after coffee and called his lawyer. The attorney's quick conclusion: Paulson's talk was material nonpublic information, and his client should immediately stop trading the shares of Washington- based Fannie and McLean, Virginia-based Freddie.

Seven weeks later, the boards of the two firms voted to go into conservatorship under the newly created Federal Housing Finance Agency. The takeover was effective Sept. 6, a Saturday, and the companies' stock prices dropped below \$1 the following Monday, from \$14.13 for Fannie Mae and \$8.75 for [Freddie Mac \(FMCC\)](#) on the day of the meeting. Various classes of preferred shares lost upwards of 85 percent of their value.

A complete list of those at the Eton Park meeting isn't publicly available. A Treasury Department roster of those expected to attend, obtained by Bloomberg News under the Freedom of Information Act, includes Ripplewood Holdings LLC CEO Timothy Collins, who says, through a spokesman, that he didn't participate.

Storied Investors

At least one fund manager who wasn't listed in the FOIA document, Daniel Stern of Reservoir Capital Group, did attend, says the manager who described the meeting.

The gathering comprised some of Wall Street's most storied investors. Mindich, a former chief strategy officer of New York- based Goldman Sachs, started Eton Park in 2004 with \$3.5 billion, at the time one of the biggest hedge-fund launches ever. Singh, a former head of Goldman's proprietary-trading desk, also began his fund in 2004, in partnership with private- equity firm Texas Pacific Group Ltd.

Lone Pine's Mandel worked as a retail analyst at Goldman before joining Julian Robertson's Tiger Management LLC, one of the most successful hedge funds of the 1980s and 1990s. He started his own firm in 1997. Och was co-head of U.S. equity trading at Goldman before founding Och-Ziff in 1994. The publicly listed firm managed \$28.9 billion in November.

Goldman Alums

One other Goldman Sachs alumnus was at the meeting: Frank Brosens, founder and principal of Taconic Capital Advisors LP, who worked at Goldman as an arbitrageur and who was a protege of Robert Rubin, who went on to become Treasury secretary.

Non-Goldman Sachs alumni who attended included short seller [James Chanos](#) of Kynikos Associates Ltd., who helped uncover the Enron Corp. accounting fraud; GSO Capital Partners LP co-founder Bennett Goodman, who sold his firm to [Blackstone Group LP \(BX\)](#) in early 2008; Roger Altman, chairman and founder of New York investment bank [Evercore Partners Inc. \(EVR\)](#); and Steven Rattner, a co-founder of private-equity firm Quadrangle Group LLC, who went on to serve as head of the U.S. government's Automotive Task Force.

Another person in attendance: Michele Davis, then-assistant secretary for public affairs at the Treasury Department, who now represents Paulson as a managing partner at public relations firm Brunswick Group Inc. In an e-mail response to Bloomberg Markets, she referred all questions to Paulson's book on the financial crisis, "On the Brink" (Business Plus, 2010), which makes no mention of the Eton Park meeting.

Paulson Thinktank

Paulson is now a distinguished senior fellow at the University of Chicago, where he's starting the [Paulson Institute](#), a think tank focused on U.S.-Chinese relations.

Eton Park's Mindich, Lone Pine's Mandel, TPG-Axon's Singh and [Och-Ziff \(OZM\)](#)'s Och all declined to comment through spokesmen. Reservoir's Stern didn't return phone calls. Altman, through a spokesman, confirmed his attendance and declined to comment further.

Brosens confirmed in an e-mail that he had attended and said he couldn't recall details. A spokesman for Rattner acknowledged he attended and said he didn't trade in Fannie Mae- or Freddie Mac-related instruments after the meeting. Chanos declined to comment.

A Blackstone spokesman confirmed in an e-mail that GSO's Goodman attended the meeting. Blackstone doesn't believe market-sensitive information was discussed, and in any event Blackstone didn't take any positions in Fannie or Freddie between the luncheon and Sept. 6, he wrote.

Strong Short Interest

Records show that many investors were betting against Fannie Mae and Freddie Mac at the time. According to [Data Explorers Ltd.](#), a London-based research firm, short interest in Fannie Mae shares rose sharply in July, to 163 million shares on July 14 from 86.3 million shares on July 9.

Short Interest continued to rise, to 240 million shares, on the day of the Eton Park meeting; it hit 262 million on July 24, its high for the year. Freddie Mac's short interest showed a similar

trajectory.

Revelations about the meeting come at a sensitive time.

“The optics are awful; there’s no doubt about it,” says professor Larry Ribstein of the University of Illinois College of Law in Champaign. “Everyone knows that insider trading is a huge issue.”

Rajat Gupta, the former head of McKinsey & Co. who was a member of Goldman’s board, was indicted by a federal grand jury on Oct. 26 for disclosing nonpublic information on Goldman and other companies to Raj Rajaratnam, a hedge-fund manager who earlier in October was sentenced to 11 years in prison for profiting from inside information provided by a web of industry insiders, including Gupta.

Gupta has pleaded not guilty.

LightSquared Probe

Several U.S. agencies face increased scrutiny in Congress for possible improper disclosures or ties to hedge funds. Senators are looking into whether the U.S. Department of Education divulged nonpublic details about new rules being considered to regulate for-profit educational institutions to outsiders, including [Steven Eisman](#), former managing director of FrontPoint Partners LLC, who held short positions in the sector.

Education Department spokesman Justin Hamilton denies any impropriety. Eisman hasn’t been accused of any wrongdoing.

In October, Republican Senator Charles Grassley of Iowa asked hedge-fund manager [Philip Falcone](#) for copies of all communications between his Harbinger Capital Partners and the Department of Commerce, the Federal Communications Commission and the White House. Grassley is looking into whether Falcone improperly sought to influence regulators and the White House while seeking approvals for LightSquared Inc., the company constructing a broadband wireless network his fund is bankrolling.

‘Government Information’

Robin Roger, general counsel for the fund’s management firm, says any assertion that the fund or LightSquared tried to improperly influence regulators is unfounded.

For government officials, the leaking of market-sensitive information, even if inadvertent, represents an ethical minefield.

“There’s a lot of government information out there, and the hedge funds are trying to get it,” says [Richard Painter](#), a law professor at the University of Minnesota who advised the Bush administration on Paulson’s sale of his Goldman stock when he became Treasury secretary. “It’s a huge problem that has to be addressed.”

The rules for what can or cannot be disclosed by government officials are often either unclear or nonexistent.

Tipping Hands

“The bottom line is that senior-level people in Washington, in the name of keeping in touch with their stakeholders, are tipping their hands,” says Adam Zagorin, a senior fellow at the Project on Government Oversight, a Washington watchdog group. “You can’t prosecute them for insider trading if they didn’t trade the shares. You may not be able to even reprimand them. What the hell are the rules?”

An official such as Paulson has no legal obligation to keep material nonpublic information to himself, says Phillip Kaplan, partner for litigation at Manatt Phelps & Phillips LLP, where he specializes in securities and class-action cases.

“I don’t think a government person is liable,” he says. “He didn’t profit from the information or trade on it.”

In the rapidly evolving world of insider-trading prosecutions, that could change, says the University of Illinois’s Ribstein, adding that the U.S. Securities and Exchange Commission is taking a broader view of what constitutes insider trading. SEC Enforcement Director Robert Khuzami, who can bring only civil cases, and the Justice Department, which can mount criminal prosecutions, have cast their net wide, Ribstein says.

Small Players Sued

In addition to going after big names like Rajaratnam and Gupta, the authorities are suing and indicting smaller players who might not have been prosecuted in the past, like accountants and analysts at so-called expert networks, who sell their expertise to hedge funds.

The University of Missouri’s Black says there’s no question that the plan to take over Fannie and Freddie -- however uncertain -- was material nonpublic information that could not be lawfully traded on. “What Paulson said put those managers in an untenable position,” he says. “They were exposed to all kinds of liabilities.”

The situation also generates some sympathy for Paulson.

“It seems to me, you’ve got to cut the guy some slack, even if he tipped his hand,” says William Poole, a former president of the Federal Reserve Bank of St. Louis. “How do you prepare the market for the fact that policy has changed without triggering the very crisis that you’re trying to avoid? What is he supposed to say without misleading these people?”

Market Insights

Poole says government officials need to communicate with industry participants in order to gain insights into market conditions and gauge likely reaction to interventions.

Black says the Eton Park meeting was the wrong way to communicate to the markets.

“Wink, wink, nod, nod is no way to approach sensitive information,” he says.

Paulson often contacted Wall Street participants throughout his tenure, according to his calendar. On that July trip to New York alone, he talked to Lehman Brothers Holdings Inc. CEO Richard Fuld, Washington Mutual Inc. CEO Kerry Killinger and Citigroup senior adviser Rubin.

Morgan Stanley and BlackRock Inc. both helped the Federal Reserve and OCC prepare the reports on Fannie Mae and Freddie Mac that Paulson told the New York Times would instill confidence the morning of the Eton Park meeting.

‘Unsafe and Unsound’

Paulson learned by mid-August that the Federal Reserve had found the GSEs “unsafe and unsound,” he told the Financial Crisis Inquiry Commission, which was appointed by President Barack Obama and Congress to probe the causes of the financial collapse.

“We’d been prepared for bad news, but the extent of the problems was startling,” he wrote in “On the Brink.”

On Sept. 6, when the GSEs’ boards agreed to have their companies placed in conservatorship, full-year 2008 losses were projected to reach as much as \$50 billion for Fannie Mae and \$32 billion for Freddie Mac. In October 2011, the FHFA estimated the cost to taxpayers of rescuing the firms at \$124 billion through 2014.

The manager who described the Eton Park meeting says he also discussed it with an investigator from the FCIC. The discussion was confirmed by a former FCIC employee.

That manager says he ended up profiting from his Fannie Mae and Freddie Mac positions because he was already short the stocks. On his lawyer’s advice, he stopped covering his short positions and rode Fannie and Freddie shares all the way to the bottom.

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