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HONG KONG SFC REPRIMANDS AND FINES GOLDMAN SACHS US$350 MILLION

On 22 October 2020, it was announced[1] that Hong Kong's Securities and Futures Commission (**SFC**) had reprimanded and fined Goldman Sachs (Asia) US$350 million (HK$2.71 billion) for serious regulatory failures that led to the misappropriation of US$2.6 billion in connection with three bond offering transactions for 1Malaysia Development Berhad (**1MDB**), a Malaysian state-owned and controlled strategic investment and development company, in 2012 and 2013.

1. 1MBD Bond Offering Transactions

a. <u>Overview of the Bond Offering Transactions and Goldman Sachs' Involvement</u>

Goldman Sachs was retained by 1MDB to assist with three bond offering transactions (the "**Bond Transactions**") in 2012 and 2013 as follows:

- Project Magnolia (raising US$1.75 billion) to purportedly partially fund the acquisition of an independent power producer);
- Project Maximus (raising US$1.75 billion) to partially fund a further acquisition of another independent power producer and related land; and
- Project Catalyze (raising US$3 billion) to fund a joint venture between 1MDB and a subsidiary of the International Petroleum Investment Company (**IPIC**), an investment fund wholly owned by the Abu Dhabi Government.

The Bond Transactions were arranged and underwritten by Goldman Sachs International, with the work itself carried out by members of deal teams in various jurisdictions. Goldman Sachs Asia, which is based in Hong Kong, had, according to the SFC, *"significant involvement in the origination, approval, execution and sales process"* of the three Bond Transactions and received 37 percent of the total revenue (US$210 million) raised from the bond offerings.

According to the SFC's findings, Goldman Sachs Asia's involvement was evident as:

- a majority of the investment bankers with a substantial role in the bond transactions were licensed persons accredited to Goldman Sachs Asia;
- Goldman Sachs Asia's Responsible Officers (**RO**) and Licensed Representatives were involved in the distribution of bonds and associated risk management;
- Goldman Sachs Asia's Business Intelligence Group (**BIG**) were responsible for conducting due diligence in relation to the bond transactions; and
- senior personnel of Goldman Sachs Asia were members of various Goldman Sachs committees which discussed, examined or approved the Bond Transactions.

1 https://apps.sfc.hk/edistributionWeb/api/news/openAppendix?lang=EN&refNo=20PR103&appendix=0

2. Goldman Sachs' Lapses in Management Oversight

The SFC found that Goldman Sachs Asia failed to detect the misconduct of Tim Leissner ("**Leissner**"), an RO of Goldman Sachs Asia and a Participating Managing Director in the Investment Banking Division of Goldman Sachs at that time, and Low Taek Jho ("**Low**"), a Malaysian financier who acted as a finder and intermediary in relation to 1MDB on a number of financial projects, including the Bond Transactions. This was despite numerous red flags which should have raised concerns in respect of the commercial rationale of the Bond Transactions and flagged AML/bribery risks.

a. <u>Misconduct of Individuals Tim Leissner and Low Taek Jho</u>

Leissner, as admitted in the US Department of Justice (**DOJ**) case brought against Leissner for conspiring to commit money laundering and violate the Foreign Corrupt Practices Act, conspired with Low and others to pay bribes and kickbacks to Malaysian and Abu Dhabi government officials to obtain and retain business from 1MDB for Goldman Sachs, which included the Bond Transactions. The Bond Transactions then generated considerable fees and revenue for Goldman Sachs, with funds raised being diverted to Leissner and others.

This misconduct went undetected by Goldman Sachs Asia, despite numerous facts which should have raised alarms, including the fact that Goldman Sachs was aware of Leissner and Low's relationship and of Low's relations with 1MDB and government officials in Malaysia and Abu Dhabi. Further, Goldman Sachs had previously rejected Low as a private wealth management client and other opportunities to advise Low given that his source of wealth could not be verified.

Low's possible involvement was also brought to the attention of various Goldman Sachs committees that vetted the Bond Transactions, yet Leissner's assertion that Low was not involved in the Bond Transactions was accepted without question or further inquiry.

The fact that Leissner was effectively only overseen by the regional and firmwide committees that vetted the Bond Transactions was found by the SFC to contribute significantly to the misconduct going undetected, as without adequate controls to monitor staff on a day-to-day basis, Leissner was, in the words of the SFC, given *"free rein in the execution of the Bond Transactions"*.

Leissner, who was previously licensed under the SFO to carry on Type 4, Type 6 and Type 9 regulated activities, has since been barred by the SFC from re-entering the industry for life.[2]

b. <u>Lack of Inquiries into Red Flags surrounding the Bond Transactions</u>

While Low's involvement was one red flag missed by Goldman Sachs, numerous other red flags were present that also went unaddressed.

Fees Earned by Goldman Sachs for the Bond Transactions

Goldman Sachs received a total of US$581.5 million in fees from 1MDB in the Bond Transactions, which was more than double the revenue generated from acting as an arranger and/or underwriter in 213 other Asia ex-Japan bond offerings between 2011 to 2015. Additionally, the mandates for the first and third Bond Transactions were awarded to Goldman Sachs without any competitive process, despite 1MDB being a state-owned entity and its willingness to pay such high fees, which should have been queried. Goldman Sachs did not however conduct any investigation in this regard and the Bond Transactions were approved.

As such, the SFC concluded that Goldman Sachs Asia failed to exercise due care and diligence in examining and approving the Bond Transactions through a failure to make appropriate inquiries in relation to the mandates and fees.

Use of Proceeds of the Bond Transactions by 1MDB

The SFC found there to be numerous circumstances which should have led to Goldman Sachs questioning the commercial rationale of the Bond Transactions, including the fact that:

- US$6.5 billion, far in excess of the funding needs of 1MDB, was raised through the three Bond Transactions within a period of only 10 months;
- Goldman Sachs was aware that 1MDB was in a weak financial position even prior to the first Bond Transaction and had a questionable ability to service existing debts;
- 1MDB requested Goldman Sachs provide principal funding (hard underwriting) for each of the bond issues despite there being no urgent need for most of the funds

2 https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=19PR60

raised and that this would result in higher fees and lower net profits; and

- 1MDB's emphasised the need for confidentiality and speed of execution.

Despite these red flags, Goldman Sachs failed to make proper and adequate inquiries prior to proceeding with the Bond Transactions.

Use of Foreign Private Banks to Receive Bond Proceeds

Adding to the questionable circumstances of the Bond Transactions was the fact that 1MDB used foreign private banks (rather than Malaysian commercial banks) to receive the net proceeds of the Bond Transactions. These included Falcon Private Bank ("**Falcon**") and BSI SA, private banks based in Switzerland. Despite Falcon being owned by a subsidiary of IPIC, Goldman Sachs made no inquiries into the payment instruction and, in the case of BSI SA, despite there being evidence linking BSI SA to Low, Goldman Sachs did not conclude there to be any AML concerns and did not question the reasoning for the deposit.

Subsequent to the Bond Transactions, Falcon was sanctioned by the Swiss Financial Market Supervisory Authority (**FINMA**) in October 2016 for breaching Swiss AML regulations in relation to its transactions and business with 1MDB between 2012 to 2015. Also in October 2016, the Monetary Authority of Singapore (**MAS**) withdrew the merchant bank status of Falcon's Singapore branch for serious failures in AML controls relating to 1MDB fund flows through the branch between 2013 to 2015.

Negative Media Reports

Further to the transaction-related concerns, there were also negative media reports which highlighted the high corruption risks associated with 1MDB, and while Goldman Sachs' Business Intelligence Group picked up on these reports, they were dismissed as being politically motivated and no adequate steps were taken to assess the veracity of the reports.

3. Hong Kong Regulatory Breaches

The SFC concluded that Goldman Sachs Asia failed to:

- diligently supervise senior personnel involved in the execution of the Bond Transactions and ensure appropriate standards of conduct were maintained (in breach of para. 4.2 of the Code of Conduct for Persons Licensed by or Registered with the SFC (the "**Code of Conduct**");
- identify and/or adequately address AML/bribery concerns despite the red flags (in breach of section 23(b) of Schedule 2 of the AMLO and para. 2.1 of the Guideline of AML and CFT);
- exercise due skill, care and diligence and act in the best interests of the its client and the integrity of the market when vetting and approving the Bond Transactions (in breach of General Principle 2 of the Code of Conduct); and
- put in place adequate and effective internal control procedures to protect clients from financial loss from fraud and other dishonest acts or professional misconduct (in breach of para 4.3 of the Code of Conduct).

Further, the SFC found that Goldman Sachs Asia's senior management failed to comply with General Principle 9 and para. 14.1 of the Code of Conduct, which requires them to bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the firm and properly manage the risks associated with the business of the firm.

4. Other Relevant Regulatory and Criminal Action against Goldman Sachs and Individuals

a. <u>Malaysian Criminal Charges</u>

In addition to the SFC's regulatory action, Goldman Sachs Asia, Goldman Sachs International and Goldman Sachs (Singapore) and 17 current and former directors were also subject to criminal proceedings in Malaysia under the Malaysian Capital Markets and Services Act. This was settled in September 2020, with Goldman Sachs agreeing to pay the Malaysian Government US$2.5 billion and a guarantee of US$1.4 billion, which saw the entities acquitted of all criminal charges and the charges against the directors dropped.

b. <u>United States Securities and Exchange Commission (SEC) Action</u>

On 22 October 2020, the US SEC announced charges against Goldman Sachs for violations of the Foreign Corrupt Practices Act (FCPA) in relation to the 1MDB Bond Transactions, to which Goldman Sachs agreed to pay US606.3 million in disgorgement (being considered satisfied by the amounts paid to the Malaysian Government) and a US$400 million civil penalty.[3]

As mentioned above, the SEC also charged Tim Leissner for violations of the FCPA, with Leissner agreeing to a settlement which involves a permanent ban from the securities industry and a payment of US$42.7 million in disgorgement (being considered satisfied by the amounts paid by Leissner under a forfeiture order as part of a plea deal in December 2019).[4]

The Federal Reserve also imposed a lifetime ban from the banking industry on former RO of Goldman Sachs Asia, Andrew Vella, over his involvement in the 1MBD Bond Transactions pursuant to a failure to escalate Low's involvement in the Bond Transactions.[5]

3 https://www.sec.gov/news/press-release/2020-265#:~:text=Goldman%20Sachs%20agreed%20to%20a,1MDB%20in%20a%20related%20settlement
4 https://www.sec.gov/litigation/admin/2019/34-87750.pdf
5 https://www.federalreserve.gov/newsevents/pressreleases/enforcement20200204a.htm

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