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UBS in Talks Over Bond Deal

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By JUSTIN BAER and JEAN EAGLESHAM

UBS AG [UBSN.VX +1.43%](#) is in settlement talks with U.S. securities regulators stemming from an investigation into a mortgage-bond deal that soured during the financial crisis, people familiar with the matter said.

The Securities and Exchange Commission's probe focuses on allegations that UBS defrauded investors in the sale of more than \$748 million in notes tied to a collateralized-debt obligation the bank created in 2007. As part of the inquiry, the regulator is also looking at the role allegedly played by a former employee of the firm that managed the assets in the deal.

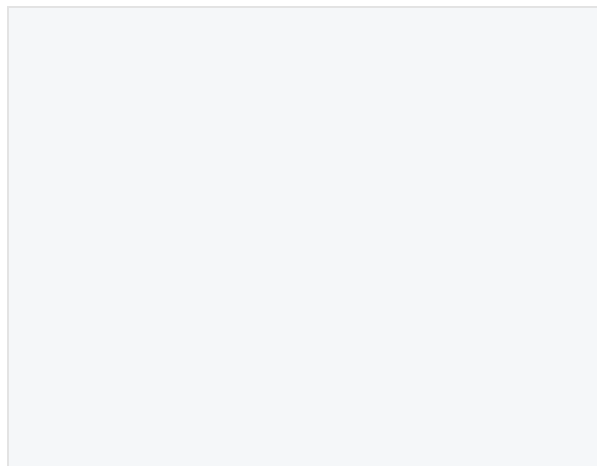
The investigation is in its late stages, people familiar with the matter said. Settlement talks with the bank are continuing, and no agreement appears imminent, the people said.

CDOs are securities linked to pools of mortgages and other debts and sold in slices of varying risks and returns. Their emergence as a popular way to bet on or against the housing market was later blamed by regulators and politicians for helping tip the credit markets into crisis five years ago, and the securities were found at the scene of some of Wall Street's most-spectacular collapses.

The bank said this month in a securities filing that it "is in discussions with the SEC concerning UBS's structuring and underwriting of one CDO in 2007."

The SEC also is probing the role of a former executive at bond insurer ACA Financial Guaranty Corp., which served as collateral manager on the deal, known as ACA ABS 2007-2.

The SEC sent the former ACA executive, Laura Schwartz, a so-called Wells notice last month indicating it is considering charges against her, according to a Financial Industry Regulatory Authority filing. According to the filing, the SEC said Ms. Schwartz is "cooperating with the investigation and denies any wrongful conduct."



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"It's still an investigation," said her lawyer, Robin Alperstein. "She's cooperating. We don't see any basis for any proceeding against her."

A spokesman for ACA declined to comment.

ACA ABS 2007-2 is also one of three CDOs at the center of a hedge-fund firm's lawsuit against UBS. The firm, Pursuit Partners LLC, accused UBS of selling CDO notes it knew would soon face credit-rating downgrades from [Moody's Investors Service](#) MCO +0.72%. Those downgrades would later drain the value of those CDO notes, resulting in losses for the hedge fund of \$35.5 million, the lawsuit says.

A judge's September 2009 initial ruling in the Connecticut case found probable cause that UBS was "privity to material, nonpublic information" on Moody's plans to change its methodologies for rating CDOs when it sold the notes to Pursuit in late summer 2007.

The court found that UBS had, in its push to entice Pursuit to buy the notes, called them "triggerless," a term frequently used to mean that holders of the CDO's supersenior tranche couldn't liquidate less senior positions to protect their investments.

The bank's use of that term, the judge found, was "akin to a representation that a gun being handed to the hedge fund wasn't loaded, when in fact UBS knew the gun was not only loaded but was about to go off."

Pursuit's lawyer, Michael Burg, said evidence uncovered in the litigation indicated that Moody's had warned UBS—and for certain deals the collateral managers—that assets in the CDOs were going to be downgraded.

A spokesman for Moody's declined to comment. UBS has previously said it intends to prevail in the litigation.

Pursuit's lawsuit against UBS, filed in March 2008, is still going through Connecticut state's courts, Mr. Burg said.

After taking large losses tied to subprime mortgages, ACA restructured in August 2008 in a plan that was supervised by Maryland insurance regulators.

Ms. Schwartz served as senior managing director and head of asset management at the company's ACA Management arm before her 2007 departure. Her name also surfaced during one the SEC's biggest cases since the crisis: Its April 2010 complaint against [Goldman Sachs Group](#) Inc. GS -0.23% and a former executive, Fabrice Tourre.

In that case, the SEC alleged that Goldman and Mr. Tourre had defrauded investors by selling a CDO whose underlying assets were handpicked by hedge-fund firm Paulson & Co. Paulson, which made billions of dollars on timely bets against subprime loans, had asked Goldman to create a CDO it could in turn short, profiting from its declining value.

ACA Management was hired to select the mortgage assets for this CDO, called Abacus 2007-AC1. Paulson helped the firm pick those assets. Ms. Schwartz worked on the Abacus deal, and in 2010 told U.S. Senate investigators that ACA believed Paulson would invest in the equity tranche of Abacus, meaning it had interest in seeing the value of the CDO rise.

In its responses to the SEC complaint, Goldman argued that Ms. Schwartz was a key figure in the discussions between ACA, the bank and Paulson over Abacus's structure. The Wall Street Journal reported in 2010 that former Paulson executive

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Paolo Pellegrini told SEC investigators that he indicated to Ms. Schwartz that his firm would buy protection against the Abacus's deterioration.

Goldman settled the complaint in July 2010, agreeing to a \$550 million fine without admitting or denying wrongdoing; the SEC's case against Mr. Tourre is scheduled to go to trial later this year. ACA has sued Goldman and the Paulson firm for allegedly conspiring to get ACA to back the Abacus CDO.

In response to ACA's suit, Goldman has argued that the insurer knew Paulson was shorting Abacus, citing a video recording between an ACA executive and a [Morgan Stanley](#) MS -0.65% trader.

Write to Jean Eaglesham at jean.eaglesham@wsj.com

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