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Probe of Insider Trading at Bear Stearns

Federal investigators are examining whether some insiders pulled money out of Bear's troubled hedge funds, while others were blocked from doing so

by Matthew Goldstein and David Henry

The investigation by securities regulators and federal prosecutors into this summer's collapse of two Bear Stearns (BSC) hedge funds that invested in risky securities backed by subprime mortgages is heating up. *BusinessWeek* has learned the Securities & Exchange Commission and the U.S. Attorney's office in Brooklyn are looking into an allegation that at least one Bear Stearns insider associated with the funds may have been pulling his personal money out of the investment vehicles this spring when the market was in turmoil. The alleged redemptions occurred, sources say, during a time the funds' managers were urging other investors to stay put.

The Wall Street Journal subsequently reported that Ralph Cioffi is the manager drawing scrutiny, after moving $2 million of his $6 million investment in the funds into another Bear-managed hedge fund. *BusinessWeek* has learned the other Bear fund in question is the $228 million Bear Stearns Structured Risk Partners fund. People familiar with the probe say investigators have been reaching out to investors in the highly leveraged funds, seeking information about the comments the funds' managers made during the spring with regard to the issue of redemptions, as well as the funds' exposure to the subprime mortgage market. The funds once controlled nearly $35 billion in collateralized debt obligations and other mortgage-backed securities, and investors lost a combined $1.6 billion when the funds filed for bankruptcy in July.

Lawyers for the funds' top managers, Cioffi and Matthew Tannin, either declined to comment on the investigation or did not return phone calls seeking comment. A Bear spokesman did not return a telephone call and an e-mail seeking comment. John Nestor, an SEC spokesman, says, "It's our policy to neither confirm nor deny investigations." A spokesman for Eastern District of New York U.S. Attorney Benton Campbell declined to comment.

REMOVED FROM THEIR POSTS

The number of hedge fund insiders under scrutiny could be greater than one or two employees. At its peak, Bear Stearns Asset Management, the alternative investment arm of the big Wall Street firm led by Chief Executive James Cayne, employed about 140 people, many of whom did work for the hedge funds. Bear has since either dismissed or laid off dozens of BSAM employees.

Cioffi and Tannin, once senior employees at BSAM, were reassigned and appointed as advisers to the asset management group. BSAM's chairman and CEO, Richard Marin, was removed from his post and also named a special adviser. Marin did not return a call seeking comment. The most high-ranking casualty of the hedge fund imbroglio at Bear Stearns was Warren Spector, the investment firm's former president and co-chief operating officer. Spector was forced out in August, after the funds fi led for bankruptcy in July, wiping out $1.6 billion in investor money. An attorney for Spector did not return phone calls seeking comment.

The issue of redemptions has been a point of frustration for investors in the elegantly named High Grade Structured Credit Strategies and High Grade Structured Credit Strategies Enhanced Leverage funds. Investors, including wealthy individuals and savvy asset-management firms, began submitting redemption notices in February, when the first signs of trouble began to emerge in the subprime housing market. Investors were told the earliest they could redeem their money was at the end of June, according to the funds' internal guidelines. But the June 30 redemption deadline was too late for most investors, as Cioffi and his team began barring investors from pulling money out the funds in early June.

GETTING BACK ON TRACK?

Ross Intelisano, a New York attorney who represents a number of hedge fund investors, says if the allegation of insiders getting preferential treatment is true, it would be bad news for Bear, which is already named in a number of arbitrations and lawsuits. "People were trying to get out as early as February and March," says Intelisano. "If you open the gates just for the insiders, it will hurt (Bear) in litigation."

Scott Berman, an attorney who specializes in hedge fund litigation, says not all insider redemptions are improper. He notes insiders could have economic reasons for pulling money out of a fund, and often the offering documents for a fund will give managers some latitude on the issue of when they can withdraw their own money.

During the spring, Cioffi and Tannin did their best to convince investors that the Bear funds were poised for a rebound. In an Apr. 30 conference call with investors, Cioffi said, "We have a plan in place that will get the funds back on track to generate positive returns." In that same call, Tannin said he was confident the "structured credit market, and the subprime market in particular, has not systemically broken down."

Meanwhile, *BusinessWeek* has also learned that the collapse of two Cioffi-led funds caused another hedge fund casualty at Bear. In recent weeks, BSAM has begun notifying investors in the Bear Stearns Multi-Strategy Fund that it plans to liquidate that $100 million investment vehicle. The fund, which only invested in Bear-managed hedge funds, put several million dollars in the Cioffi-led funds.

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