Bay State Targets Bear Stearns: Emails suggest managers of collapsed funds saw liquidity crisis on the horizon

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Investment Dealers Digest- In the latest development surrounding Bear Stearns' conduct relating to two collapsed hedge funds, the Massachusetts Securities Division earlier this month accused the company of fraud. At the same time, lawyers representing other investors claim to have proof, through email correspondence, that Bear knew of a severe liquidity crisis yet continued to market the two funds, the High Grade Structured Credit Strategies Master Fund and the High Grade Structured Credit Strategies Enhanced Leverage Master Fund.

These allegations add to the numerous complaints already filed, and to the Securities and Exchange Commission and the Brooklyn US Attorney's investigations into the funds. Both the SEC and the Brooklyn US Attorney declined to confirm or deny investigations, but a source close to the US Attorney's Office says the investigation is "ongoing."

"We are declining to comment on this ongoing regulatory matter," a Bear Stearns spokesman says.

The Massachusetts complaint alleges that Bear Stearns Asset Management (BSAM) violated securities laws by failing to notify the hedge funds' independent directors that it was trading securities from its own accounts with hedge funds it also advised, and that as such, investors in the BSAM funds were exposed to more conflicts of interest than investors in most other hedge funds.

A spokesman for the Secretary of the Commonwealth of Massachusetts, William Francis Galvin, declined to comment beyond the complaint. The BSAM funds invested in special purpose vehicles structured by the managers of the funds themselves, bought and sold securities from those special purpose vehicles and bought and sold securities from the affiliated broker-dealer, Bear Stearns & Co., the complaint reads.

Under state and federal securities regulation, consent from independent directors - which at BSAM is called a principal trade letter - is necessary to conduct such transactions.

However, of the transactions that required prior approval by the unaffiliated directors, nearly 79% were missing such approval in 2006, according to the complaint. Bear Stearns subsequently decided to impose a freeze in the early fall of 2006 on all transactions between the High Grade Fund and Bear Stearns, which "reveals the depth and gravity of the breakdown," the complaint says.

Following the moratorium, the funds' managers, Ralph Cioffi and Matthew Tanin, began to express concerns about the liquidity of the High Grade funds, the complaint further alleges, citing email communications it used as exhibits.

In an email Tanin sent Cioffi, dated Sept. 17, 2006, he writes: "I think we need to have a very specific idea of how we would raise $100 million in liquidity over a 60-day period. While I do not expect this, I think it is possible."

The moratorium lasted until May or June 2007, according to the complaint, but neither the liquidity concerns, nor the moratorium itself, were communicated in the High Grade fund's August 2006 private placement memorandum.

"According to the emails between Tanin and Cioffi they knew they were in danger of being wiped out because of the liquidity problem but they continued to sell the hedge funds through spring of 2007. It's stunning they continued knowing they would have a lack of liquidity in the fund," says Ryan K. Bakhtiari, a partner with Uhl & Bakhtiari, which is part of a consortium of law firms - Aidikoff, Maddox, Hargett & Caruso, David P. Meyer & Associates and Page Perry - that are representing investors in the Bear funds and filed claims with the NASD arbitration tribunal.

"I represent investors that bought in the fund in March 2007 and their money was wiped out in a couple of months. I'm sure they would have liked to know there was no liquidity before putting their money in," Bakhtiari says.

According to Bakhtiari, Bear Stearns, which was deeply involved in the loan origination and the securitization process, used the hedge funds as a conduit for the firm to pass through low-quality securities. Bear Stearns, he says, was at that time the No. 1 underwriter of mortgage-backed securities with an 11% market share, hence "acutely aware of the MBS and housing market issues."

"I think that the evidence that the state of Massachusetts and private attorneys will uncover may demonstrate that the hedge funds were a dumping ground," he says. "It seems to me when you are dominating the underwriting market and you know about mortgages and tell people that their investments in the two funds were going be in AAA' and AA' credit, knowing what you knew about the market at that time, was very misleading."

Several industry observers backed the sentiment, saying the Massachusetts Securities Division has taken a different route - concentrating on compliance and approval procedures which were not followed - to get to the same set of facts.

"They may have been dumping allegedly low-quality securities into the hedge funds at unfair prices," says New York-based lawyer Jacob Zamansky of Zamansky & Associates, who is representing several investors and who filed a complaint with the NASD arbitration tribunal in August. "When people don't follow procedures, there is generally a reason for it."

In addition, this latest development may help the private attorneys' cases as "the exhibits to the complaint are particularly illustrative of the fact that the true financial difficulties of their hedge funds were known and concealed by the insiders at Bear Stearns," says Steven B. Caruso, a partner at Hargett & Caruso. "The fact that a state regulator initiated this complaint, and exposed the depth of

this apparent scheme, is yet another example of the SEC being a day late and a dollar short when it comes to investor protection."