

## INVESTMENT DEALER'S DIGEST

October 15, 2007

### **Bear May Have to Answer to the Feds**

#### *Latest Investigation Comes on Heels of SEC Inquiries*

By Yael Bizouati

The Brooklyn US attorney has started an investigation into the collapse of the two Bear Stearns hedge funds - its High Grade Structured Credit Strategies Master Fund and its High Grade Structured Credit Strategies Enhanced Leverage Master Fund - that had subprime exposure, sources familiar with the matter say.

"You could expect that a lot of federal regulators would look into it," a source says, adding that no subpoenas have been issued yet and that federal prosecutors have started asking "very informal questions."

Bear Stearns declined to comment on the matter. The spokesman for the Brooklyn US attorney's offices neither confirmed nor denied the existence of an investigation.

This latest development follows the widely reported investigation that the Securities and Exchange Commission recently launched into the funds - although the SEC also declined to confirm or deny its investigation.

The potential fallout stemming from a federal criminal probe could be disastrous for Bear and might involve injunctions, disgorgements and financial penalties, several sources say. Others go further, saying that if an investment bank or a commercial bank is found to have violated a criminal statute, it would

potentially be a material risk to the continued viability of the bank's business.

"Historically in the securities industry, investigations, if they result in something as serious as an indictment, can be very significant for firms and have a major impact on them," says Peter Wallison, a former White House counsel to President Ronald Reagan who is now a co-director of the American Enterprise Institute's program on financial markets deregulation, "because what has to have occurred is something that would reflect efforts to mislead. In addition, it could well cause your employees to become disheartened and demoralized and leave, and your customers would go elsewhere."

Criminal charges would also have a major impact on any civil cases. "The US attorney's investigation would take this to a whole new level," says New York-based lawyer Jacob Zamansky of Zamansky & Associates, who is representing several investors and has filed a complaint with the NASD arbitration tribunal.

"We've been told there are millions of e-mails going back and forth between Bear Stearns and the rating agencies and the portfolio managers, and I think that's what they may be

looking at," he says. Zamansky declines to comment on whether he is in possession of such e-mail communication, saying instead: "We've been conducting our own investigation."

The relationship between the rating agencies and the firm is a matter many lawyers are increasingly looking into. "I look forward to the day when I can read and review the e-mail communication between the Wall Street underwriters and their counterparts in the rating agencies as they rated and negotiated these investments," says Tom Hargett, a securities attorney with Maddox Hargett & Caruso, a law firm that's part of a consortium representing Bear Stearns investors.

Meanwhile, Ohio Attorney General Mark Dann has made it his mission to uncover what went on in the subprime quagmire and has launched a probe into credit rating agencies and the secondary market.

"The rating agencies' relationship with the investment banks was very collaborative, and they may potentially have some liability," he says. "A lot of people made a lot of money. Mortgage brokers, appraisers, lawyers, accounting firms and rating agencies were paid billions of dollars. They benefited from the system."

Dann says he is disappointed with the lack of intensity and diligence with which federal regulators have investigated the subprime business and says they have been less than forceful in effectively policing the securitization market in recent years.

"The SEC hasn't exactly been aggressive on the matter, they have been more Inspector

Clouzot than James Bond," he says. "They'd rather look into munibond deals, which aren't exactly the terror of Wall Street."

As for Bear, some industry insiders say the firm probably isn't looking at a business-altering event.

"There will be no implications here. They will be fined, end of story," says Charles Gradante, managing principal and co-founder of Hennessee Group, a New York-based hedge fund investment advisory firm. "They didn't do what Anderson or Enron did. In my mind, there was no aiding and abetting; it was miscommunication. Bear Stearns is likely to come out with some scars to remember, but it is unlikely it will take the firm down."

Gradante believes there are two kinds of frauds - premeditated and accidental - and that Bear's case was the latter. "When you sign off [on] documents for hedge funds, it says that you may lose all your money. This was just a miscalculation of risk, it snowballed, and in their heart of hearts, they may have thought the funds would come back. They're guilty with an explanation."

Christopher Clark, a former federal prosecutor and now a partner at Dewey & LeBoeuf, echoes the sentiment, saying the investors involved were qualified and knew what they were getting into. "To say Bear didn't disclose enough of the risk of subprime is kind of ridiculous, because these are a bunch sophisticated investors who understand the risks. The only viable case would be that either someone acted with malfeasance or if they lied about what they had really invested in."