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Bear Stearns Draws Probe on Fund Trades

Massachusetts Looks at Possible Conflicts before Vehicles Failed

By Jennifer Levitz

Massachusetts securities regulators are investigating whether Bear Stearns Cos. improperly traded with two in-house hedge funds that collapsed this summer, saddling investors with added losses.

Regulators in the office of Secretary of State William F. Galvin specifically are examining whether Bear Stearns traded mortgage-backed securities for its own account with the hedge funds without notifying the funds' independent directors in advance, people familiar with the investigation said.

Advance disclosure of so-called principal trades is a "longstanding principle" for investment companies, said Howard Schiffman, a securities lawyer and former enforcement lawyer at the Securities and Exchange Commission. He said a fund could be accused of breaching fiduciary duty if proper disclosure was not made. "You need assurances that you're going to deal fairly from the fund's point of view," he said.

Investigators are attempting to determine whether the trades were priced fairly and whether troubled securities positions were offloaded onto investors in the two funds, among other things, people familiar with the probe said. Such mortgage securities are priced by dealers who do not publish quotes; it's often difficult to determine their market values.

The failure of the two mortgage-related funds, Bear Stearns High-Grade Structured Credit Strategies Fund and High-Grade Structured Credit Enhanced Leverage Fund, cost investors \$1.6 billion. The state believes it has standing on behalf of Massachusetts investors in the funds.

Federal prosecutors and the SEC each are examining the circumstances surrounding the funds' collapse. The Massachusetts investigation appears to be the first suggestion that potential conflicted trading at Bear Stearns is being scrutinized. Massachusetts regulators have found "a material number of principal transactions," between Bear Stearns and the two funds, a person familiar with the investigation said.

A Bear spokesman, Russell Sherman, said the firm doesn't comment on investigations but is cooperating with all inquiries about the two funds.

The case underscores the myriad conflicts facing diversified Wall Street securities firms that sponsor their own hedge funds. When acting for the firm's own account, for example, Bear Stearns traders have a primary responsibility to make money for Bear Stearns, not for the mostly investor-owned hedge funds, and they routinely seek the best prices for the firm.

The Bear Stearns funds' offering memorandums listed 12 other types of arrangements that could lead to conflicts, including handling brokerage business for the funds, allocating positions between the funds and other entities managed by Bear Stearns, valuing the assets of the partnerships, and lending to the funds.

As the memorandums note, federal securities law mandates that any investment adviser whose affiliates engage in principal trading with clients must obtain their consent in writing in advance. Bear Stearns Asset Management, the unit that sponsored the two funds, promised in the memorandums that it would do this by obtaining the consent of the funds' independent directors, who act on behalf of investors.

The Bear Stearns hedge funds each had the same five directors, three of whom were affiliated with Bear Stearns. The independent directors were identified in the memorandums as Scott P. Lennon, and Michelle Wilson-Clarke, both executives at Walkers SPV Ltd., a fund administrator in the Cayman Islands, where both funds were incorporated. Mr. Lennon didn't return a phone call seeking comment. Ms. Wilson-Clarke referred calls to the funds' legal counsel, Mark Parrott, also at Walkers, who declined to say whether the funds had adhered to the disclosure requirements.

The two funds, one launched in 2003 and the other in 2006, had reaped a string of quarters with positive returns. When the market for subprime home loans went downhill, so did many of the funds' holdings. Prominent in the funds were pools of securities made up of bonds backed by subprime mortgages, which are extended to borrowers with poor credit.

"I was in disbelief" about the losses, said investor Ronald Greene, a 79-year-old retired metals engineer who lives near San Jose,

Calif. Mr. Greene said he invested in High-Grade Structured Credit last year during a window that let in investors with only \$250,000, compared with the typical \$1 million entry fee.

Mr. Greene, who has filed an arbitration claim with the Financial Industry Regulatory Authority against Bear Stearns, said his financial adviser, a hedge-fund broker in Iowa, told him the fund was conservative and dealt in "high-grade" securities. Mr. Greene said he lost his entire initial \$250,000 investment, plus \$43,000 in gains, when the fund collapsed.

"I couldn't believe it; this was really supposed to be a top Wall Street firm," he said. His lawyer, Jacob Zamansky, of New York, said he is representing 25 Bear Stearns hedge-fund investors, four of whom have filed arbitration claims.

Bear Stearns's Mr. Sherman said the allegations in the arbitrations are "unjustified and without merit," adding that "the accredited, high-net-worth investors in the fund were made very aware this was a high-risk, speculative investment vehicle."

As previously reported, Massachusetts regulators are looking at why Bear Stearns research analysts upgraded subprime lender New Century Financial Corp., a real-estate investment trust based in Irvine, Calif., from "sell" to "neutral" on March 1, just before New Century filed for bankruptcy proceedings.

The state is examining whether Bear Stearns made loans to New Century that may have affected the stock recommendation, people familiar with the inquiry said. A subpoena in that inquiry elicited responses that led investigators to the area of principal transactions, these people said.

Mr. Sherman said Bear Stearns is cooperating fully with investigators looking into New Century.