US: Bear Stearns hedge fund managers indicted

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Federal prosecutors indicted two former Bear Stearns hedge fund managers on charges of securities, mail, and wire fraud last Thursday. Funds operated by the two executives, Ralph Cioffi and Mathew Tannin, folded in June of last year, taking some $1.6 billion of investor funds down with them.

Cioffi and Tannin are the first Wall Street executives to be prosecuted in connection with the credit crisis. The collapse of their funds came relatively early in the crisis, during the spring of 2007, and their failure helped set off a fire sale that led ultimately to the Federal Reserve bailout of Bear Stearns in March of this year.

The legal charges against the two are based on their having misled wealthy investors as to the real values of the funds shortly before they collapsed. The managers sought to add additional capital to ensure their solvency, and allegedly sought to paint the opportunity in the best possible light for prospective investors. “Believe it or not I’ve been able to convince people to add more money,” Tannin wrote in an email exchange with a colleague.

Ralph Cioffi also faces insider-trading charges after allegedly moving $2 million of his own assets out of the fund before warning other investors. Bear Stearns has already settled over a dozen shareholder lawsuits against the two men.

The funds generated profits by borrowing money in the short term to make investments in longer-term mortgage-backed securities. These obscure assets were given very high credit ratings by rating agencies, and subsequently were valued independently of market pricing by the hedge funds’ own models. This strategy led to massive short-term gains; one of the funds saw a 40 percent return in 2006 alone.

But these gains—representing little more than leveraged speculation on the real estate bubble—concealed equally great risk. The funds’ assets plunged in value when sub-prime mortgage borrowers started defaulting on their loans in record numbers, and, despite the alleged concealment of the funds’ real value by their managers, they could not raise enough capital to cover their obligations.

Cioffi’s attorney noted that, although the two funds were among the first to suffer from the crisis, “dozens of the largest financial institutions have lost over $300 billion to date on the same investments.”

“Matt Tannin is innocent, he is being made a scapegoat for a widespread market crisis,” said his attorney Susan Brune.

Indeed, prosecutors subjected the two defendants to the “perp walk,” parading them in handcuffs before the television cameras outside the federal courthouse in Brooklyn. The scene was broadcast on the nightly news by all the major networks.

To the extent that the two are “scapegoats,” it is because their case is emblematic of the thoroughgoing rot that pervades the whole financial system. Following the hedge funds’ collapse, it has become evident that their strategy was semi-fraudulent, and that its leadership likely crossed over the line of legality. But this could be said about a great deal of Wall Street activity in recent years.

A hedge fund manager recently wrote in to the *Financial Times’* advice column, saying, “I genuinely don’t believe it is possible to do [my] job—outperforming other fund managers and equity indices—with any consistency. I believe the industry is based on the lie that fund managers add value through skill, rather than luck.” There are, of course, ways to “force” luck, and Wall Street found many such measures. After all, how could hedge funds—such as those run by Cioffi and Tannin—consistently outperform expectations by a margin of 20 percent?

The answer—to put it bluntly—was to inflate returns by hiding risk. This is what the two funds specialized in, and what brought them huge returns and plaudits from analysts. But, ultimately, the Bear hedge funds—together with others that sprung up to create, distribute, and buy mortgage-backed securities—could only be profitable so long as housing prices continued to rise, and imploded after the bubble began to deflate.

The indictment of the two managers is among the most high profile of numerous cases of "rogue" and illegal trading that have come out in recent months. Morgan Stanley announced last week that it had lost some $120 million after a rogue trader's deals went sour. This follows announcements from Credit Suisse and Lehman Brothers along similar lines. In January, Société Générale, the French Bank, accused low-level trader Jérôme Kerviel of contributing to the loss of some €4.9 billion ($7.6 billion).

The reality is that, if these unauthorized trades had turned out to be profitable, the traders who organized them would have been branded as "innovators" and handed huge bonuses. Wall Street has become a place where the line between legitimacy and illegality, violation and compliance is routinely blurred, where unimaginable sums are awarded for "risk-takers" who get lucky. As one trader who made a great deal of money in mortgage-backed securities recently told this writer: "Was what I did wrong? I hope not."

The indictments came alongside a continued influx of reported bank losses. Lehman brothers confirmed this week that it suffered a $2.8 billion loss in the second quarter, and Morgan Stanley announced Wednesday that its profits fell by 58 percent compared to the second quarter of 2007. A large section of the losses—$1.7 billion—came in the form of debt write-offs, but a significant portion came from trading in commodities prices. "We made a contrarian bet on energy that went wrong," said the firm's chief financial officer, sounding more like an apologetic gambler than a major executive. "But we will make bets where we feel they are warranted," he continued.

Meanwhile the overall economic outlook has continued to worsen. After predicting a deepening of the US slowdown, the Royal Bank of Scotland observed in a report last week that "People are beginning to wake up to the view that 2009 growth will be stagnant and weaker than 2008."

John Paulson, a top-earning hedge fund manager in 2007, observed, "We're only about a third of the way through the writedowns," adding, "There are a lot of problems out there and it will continue to be felt through the year. We don't see any signs of stabilizing." Paulson predicts that total write-offs stemming from the credit crisis may total $1.3 trillion. A recent report by the IMF echoed these sentiments, noting that the US economy would likely "stagnate" despite tax rebates and low interest rates.

Under these conditions, the banks are working to curb their speculative excesses, smooth out their balance sheets and purge bad debt. As the super-rich make a show of getting their house in order, they will move to condemn those executives and fund managers who committed the most flagrant offenses against billionaire shareholders. But the people most responsible for the crisis— the senior executives of Bear Stearns, Morgan Stanley, Goldman Sachs, etc.—and the massive public harm that it caused, not to mention the system of financial parasitism itself, have remained essentially free of public scrutiny.