Bear Indictments Prompt Review of Operating Procedure

The indictment last week of two former Bear Stearns hedge-fund managers has potential for a second act no matter how the case ends -- as a manual for handling sensitive hedge-fund issues, ranging from questions about redemptions to the proper use of email.

When the window for withdrawals opens during tough markets, like this one, the tug-of-war intensifies between hedge-fund investors hungry not only for information about fund performance but also about whether coinvestors are jumping ship or staying the course.

The Bear Stearns-funds indictment alleges that, last spring, as hedge-fund manager Ralph Cioffi addressed the issue of redemptions on an investor conference call, he misled listeners about investors' redemption plans and didn't reveal his decision to pull some of his own money from the fund.

He and his co-defendant, Matthew Tannin, are fighting the charges and maintain their innocence. Bear, after its near-collapse, is now part of **J.P. Morgan Chase** & Co.

"This case has hedge-fund managers talking about how they handle conversations about what the future could be for their funds," says [Jahan Raissi](), a former Securities and Exchange Commission enforcement attorney who's now a lawyer focused on securities law in San Francisco.

Messrs. Cioffi and Tannin managed funds whose holdings in mortgage-backed securities plummeted in mid-2007, eventually costing investors in the Bear Stearns funds $1.6 billion. The June 18 federal indictment alleges that the men misled investors about the health of their portfolio and their financial interests in the funds and investor redemptions.

The indictment alleges that, as Mr. Cioffi referred to the redemptions as "the big -- obviously, the question that we've been getting from a number of investors," he failed to tell investors about more than $50 million in withdrawals about to hit the funds last spring but instead said "I believe we only have a couple million of redemptions for the June 30 date."

Mr. Cioffi also allegedly kept silent about $2 million he personally had pulled from one of the funds, according to the indictment. He reinvested that money in another, new Bear Stearns hedge fund investing in structured debt so that he would be taking risks alongside investors in that fund also, according to people familiar with his actions.

Also, these people say, the managers believed that some clients who had put in redemptions planned to change their minds and keep money in.

Lawyers say that in general hedge-fund managers have few legal obligations regarding disclosure beyond telling the truth. Some managers have partnership agreements in place, especially with powerful pension funds and other big investors, promising more-detailed disclosure, such as saying when hedge- fund managers withdraw their own money.

At the same time, managers tend to want to avoid being too specific about how much money is walking, for fear of causing a crisis of confidence that leads to more withdrawals.

"Managers almost always play very close to the vest what their redemptions are looking like coming up to the deadline for redemption requests, and the worse things get, the more cagey they get," says Scott Baker, a principal at Cook Pine Capital, a Greenwich, Conn., firm that has about $200 million in client money invested with hedge funds. "I pretty much want to hear a hard number for redemptions, and the managers you trust most will give you that."

Disclosure obligations generally boil down to the materiality of the information in question, lawyers say.

"Would a reasonable investor find that information useful in making an investment decision -- to stay in or get out?" says attorney Jay Gould, head of the hedge-funds practice at Pillsbury Winthrop Shaw Pittman LLP in San Francisco. Absent a clearly agreed-upon obligation to disclose the amount of redemptions or requested withdrawals, the cardinal rule is to avoid misleading investors, says Mr. Raissi. "If the redemption number's $50 million you can't say it's $5 million."

Some managers guarantee investors that partners will keep a certain minimum amount of their own money -- say, 10% of a fund -- invested at all times. The Bear funds case has prompted discussions about making such language less precise so that partner withdrawals are less likely to require disclosure to clients.

One manager of a fund with more than $10 billion recently postponed a planned withdrawal, because investors are particularly sensitive to such moves in this market, according to a person familiar with the situation.

The indictment spotlights the case for email restraint, some lawyers add. The document quotes emails in which the defendants articulate their fears of the market -- in one instance calling the outlook for subprime investments "toast." The case has reignited discussions among hedge-fund lawyers and executives about doing more-frequent cleanups of computer systems to wipe out emails.

Two lawyers for two hedge-fund firms with combined assets of more than $25 billion said they've tried to ban the use of the popular Bloomberg messaging system for anything but the most innocuous statements, such as about meeting times or lunch plans.

Bloomberg retains all messages sent through its terminals for at least five years, according to a spokeswoman for the New York company.

The spokeswoman says that more than 52 million messages are sent daily over Bloomberg and that financial professionals like the system's speed and compliance features, among others.