

Recent Developments in Government Investigations of Financial Fraud

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The author suggests that recent acquittals in the Bear Stearns hedge fund case demonstrate that, even in the current economic climate, guilty verdicts against financial executives charged with fraud are not foregone conclusions.

The recent acquittals in the trial of Ralph Cioffi and Matthew Tannin, the former Bear Stearns hedge fund managers who were charged with committing securities fraud, represented a milestone of sorts in the wave of regulatory and criminal investigations spawned by the deterioration of subprime mortgage-related assets. Starting approximately a year and a half ago, federal, state, and local government agencies throughout the United States opened myriad investigations seeking to uncover the reasons (and possibly to apportion blame) for some of the losses experienced during the economic downturn. While many such efforts started with public fanfare, the criminal charges against Cioffi and Tannin appear to be the only criminal prosecutions that have been brought thus far. Given that those charges failed to stick, some commentators have speculated that the government will now be chary of bringing criminal charges in other subprime-related cases. No matter which way the charging decisions ultimately turn, however, it is apparent in the immediate aftermath

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of the verdict that the government is continuing to investigate as vigorously as ever. In particular, the government's investigations have involved close scrutiny of investment and trading decisions with a focus not only on traditional financial institutions, but also on hedge funds and other less traditional (and less regulated) entities that participate in the securities and derivatives markets. As demonstrated by the Bear Stearns trial, however, determining the true motivation for prior investment decisions is not always a simple exercise.

THE BEAR STEARNS HEDGE FUND MANAGERS' TRIAL

Bear Stearns hedge fund managers Matthew Tannin and Ralph Cioffi ran subprime-heavy funds that collapsed in June 2007. In what were reportedly the first criminal charges arising out of the credit crisis, the U.S. Attorney's Office for the Eastern District of New York charged Tannin and Cioffi with securities fraud, wire fraud, and conspiracy in June 2008, alleging primarily that the two had made misrepresentations about the health of the funds to their investors. After a four-week trial, both Tannin and Cioffi were acquitted on all counts on November 10, 2009.

At trial, the government's case consisted primarily of internal e-mails by Tannin and Cioffi that were selected for their seeming inconsistency with the managers' public statements. The defense countered largely by presenting a broader context for the e-mails, attempting to show that the defendants did not intentionally mislead investors, but rather held mixed views about how the depressed market could affect their funds. The government was unable to present as many e-mails as it had hoped, however, because the defense won a pretrial motion to exclude evidence from Tannin's personal e-mail account on the grounds that the search warrant issued for that account was unconstitutionally broad.¹ The judge held that the warrant had not properly limited the items to be seized from Tannin's personal account to e-mails containing evidence of the specific crimes charged in the indictment or even to those containing evidence of any crimes.

The defense witnesses included R. Glenn Hubbard, who was an economic adviser to George W. Bush and is currently the Dean of Columbia Business School, and Richard Marin, the former head of Bear Stearns

Asset Management.² Hubbard provided expert testimony that the funds failed because lenders stopped extending credit. He opined that if the credit lines had remained open and the funds had continued with their existing investment strategies, the funds would have earned upward of \$1.35 billion. Marin testified that at an April 2007 meeting with Cioffi, Tannin, and four other fund managers, everyone agreed that Bear Stearns should invest \$25 million in one of the defendants' funds, thereby bolstering the notion that the negative market conditions were viewed by some as presenting a good buying opportunity.

Tannin and Cioffi still face a civil action by the Securities and Exchange Commission ("SEC"). The SEC charged the two with Securities Act and Exchange Act violations one day after they were indicted on criminal charges.³ After the criminal trial verdict, the SEC indicated that it nevertheless planned to go forward with its enforcement action.

RECENT INVESTIGATIONS

At both the state and federal levels, the SEC, the Department of Justice ("DOJ"), and other regulatory agencies have been investigating the credit derivatives markets for instances of individual fraud and for large-scale market manipulation. The various investigations have employed administrative requests, subpoenas, and threats of prosecution to gather information. Some of the key investigations that have been disclosed to the public concern auction rate securities, short selling, collateralized debt obligations ("CDOs") and credit default swaps ("CDSs"), and financial institution securities.

Auction-Rate Securities

The SEC and many states' Attorneys General have conducted investigations into the marketing of auction-rate securities, leading to settlements with companies including Merrill Lynch, UBS, TD Ameritrade, Bank of America, Goldman Sachs, Deutsche Bank, JP Morgan Chase, Citigroup, Credit Suisse, and Wells Fargo. These settlements have required the banks to buy back auction rate securities (collectively over \$61 billion to date) and, in some cases, have imposed monetary penalties.

Short-Selling

The SEC, the New York State Insurance Department, and the New York State Attorney General have announced investigations into the potential manipulation of the stock market by short-sellers. These investigations have involved subpoenas to numerous market information providers, as well as to hedge funds for their trading activities and holdings.

Credit Default Swaps

The SEC and the DOJ are probing market manipulation stemming from CDSs, and the SEC has required some hedge fund managers to disclose their trading activity in CDSs. In May, the SEC brought its first action for CDS-related insider trading against two individuals, one of whom was a hedge fund portfolio manager.⁴ The New York State Attorney General and the DOJ have also announced a joint investigation into the role of CDSs in the financial crisis,⁵ which has since requested information from entities including stock exchanges, investment firms, and clearing firms.

Individual Entity Investigations

The DOJ and the SEC have commenced investigations into the accounting practices and corporate governance of Fannie Mae, Freddie Mac, Lehman Brothers, and AIG.⁶ Such investigations have focused on the valuation decisions reflected in the entities' financial statements and public disclosures regarding their financial health.

THE INTERAGENCY FINANCIAL FRAUD ENFORCEMENT TASK FORCE

On November 17, 2009, Attorney General Eric Holder announced the launch of an interagency Financial Fraud Enforcement Task Force to combat financial crime. The purpose of this new task force, which appears to supersede the Corporate Fraud Task Force established by the Bush Administration after Enron, is to “investigate and prosecute fraud and financial crime” and to ensure that “unscrupulous executives, Ponzi scheme operators, and common criminals” are punished for their actions.⁷ In his speech

announcing the new task force, Holder indicated that the government intends to devote more resources toward punishing past wrongdoers and preventing future actions that could lead to further economic meltdown. While it is too early to tell whether the Financial Fraud Task Force will differ substantively from its predecessor, the name change alone signals an intent to broaden the focus beyond corporations and corporate executives.

The Cioffi/Tannin acquittals demonstrated that, even in the current economic climate, guilty verdicts against financial executives charged with fraud are not foregone conclusions. Far from portending a retreat from criminal prosecutions, however, the Cioffi/Tannin verdict more likely will simply cause the DOJ to redouble its efforts to bring high-profile financial cases. For its part, the SEC, by announcing that it will continue to press its case against Cioffi and Tannin, also seems undeterred. As demonstrated by the SEC's insider trading action related to CDSs and the public statements of Enforcement Director Robert Khuzami, the SEC is actively trying to broaden its reach to include areas previously unregulated by the SEC. There has been an accumulation of civil actions — and civil penalties — imposed by the SEC and other regulatory agencies, but, as Judge Rakoff has demonstrated, even mutually agreed-upon resolutions may not successfully conclude such matters. Thus, it is both necessary and prudent to respond to the government's investigations with appropriate caution and care.

NOTES

¹ Amended Memorandum and Order, *United States v. Cioffi and Tannin*, No. 08-CR-415 (E.D.N.Y. 2009).

² Patricia Hurtado and Thom Weidlich, *Ex-Bear Fund Managers Not Guilty of Subprime Fraud*, Bloomberg, Nov. 10, 2009, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=adMRekz7o4Yw&pos=1>; Hugh Morley, *Cioffi Defense Opens*, North Jersey.com, Nov. 2, 2009, available at http://www.northjersey.com/news/crime_courts/crime_courts_news/Cioffi_defense_opens.html.

³ *SEC Charges 2 Former BS Hedge Fund Managers with Fraud*, 2008-1115 (June 19, 2008), available at <http://www.sec.gov/news/press/2008/2008-115.htm>.

⁴ *SEC Charges Hedge Fund Manager and Bond Salesman in First Insider Trading Case Involving Credit Default Swaps*, 2009-102 (May 5, 2009), available at <http://www.sec.gov/news/press/2009/2009-102.htm>.

⁵ Vikas Bajaj, *Joint U.S.-New York Inquiry Into Credit-Default Swaps*, N.Y. TIMES, Oct. 20, 2008, at B4.

⁶ Reuters, *Mortgage Firms Subpoenaed*, N.Y. TIMES, Sept. 30, 2008, at C9.

⁷ Eric Holder, U.S. Att'y Gen., Remarks at the Financial Fraud Enforcement Task Force Press Conference (Nov. 17, 2009) (transcript available on DOJ website at <http://www.justice.gov/ag/speeches/2009/ag-speech-091117.html>).