

The Fed's Subprime Suspect

The Justice Dept. and the SEC are investigating Ralph Cioffi, who ran the Bear Stearns funds that ignited the credit crisis

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Business Week – These are anxious days for Ralph R. Cioffi, the former manager of the two Bear Stearns ([BSC](#)) hedge funds whose collapse last summer sparked the credit crisis. Federal prosecutors are expected to decide by June whether or not to bring charges against him and members of his team. Wall Street is watching closely: If the Justice Dept. can't make a case against Cioffi, a prime figure in the mortgage mess, other criminal investigations may hit a dead end as well.

The inquiry's pace has quickened in recent weeks, with investigators from the office of the U.S. Attorney in Brooklyn, Benton J. Campbell, talking to the funds' wealthy investors. Prosecutors have also urged some lower-level Bear employees to hire criminal-defense lawyers in preparation for official interviews. The SEC, which can pursue a civil case, is also conducting an investigation into what happened at the funds.

THE SEARCH FOR A SMOKING GUN

The probe is moving forward on two fronts, looking at whether the managers deliberately misled investors about the funds' health and whether Cioffi and his team conjured up fraudulent values for the funds' risky subprime securities. The latter is what matters most to other investment banks. The issue of how Wall Street priced those collateralized debt obligations, the values of which were based on internal models rather than actual values, has been controversial ever since the market for them evaporated last year. **"If the valuations become a criminal issue [for] Bear Stearns, it would send a warning shot across the bow of every firm that marketed these exotic products," says Steven B. Caruso, a litigator representing several Bear investors.**

But proof of such fraud is hard to find, much less explain to a jury. Prosecutors need evidence that the managers intentionally put a false price on a security. In other words, it usually comes down to a smoking-gun e-mail. "You need a debate that ends with someone saying: 'I don't care what the facts are, we are going to use this valuation,'" says former top federal prosecutor David Esseks, now a partner at Allen & Overy in Manhattan.

The subprime mess only muddles matters. Lawyers note it wasn't just a few funds that may have relied on faulty pricing models. Rather, the problems seem to have permeated the entire financial system, given the \$250 billion in subprime-related writedowns so far. "This was a Street-wide failure," says another former federal prosecutor.

BUILDING A CASE

Those challenges may explain why prosecutors are spending so much time interviewing investors, pursuing a line of questioning that may prove more fruitful for making charges than the valuation angle. Investigators are focusing on what Cioffi and his team were saying and doing in the months before the funds fell apart, including whether they downplayed the number of investors rushing to the exits. They're also looking for inconsistencies between Cioffi's bullish comments on conference calls and his e-mails or other communications.

As prosecutors debate how to proceed, Cioffi waits at his multimillion-dollar home in Tenafly, N.J. But he still has a hand in the finance game. Earlier this year, Cioffi and a former colleague started an investment vehicle called RCAM Capital. People close to Cioffi say it's only to manage family money. But he has registered a domain name for RCAM and hired a Web designer to construct a site.