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HEDGE FUNDS

Hedge Funds in the Crosshairs: The Year in Review

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A. Introduction

1. 2008: A Watershed Year in Hedge Fund Enforcement.

By virtually any measure, 2008 was a watershed year on the hedge fund enforcement front. Driven by the turmoil that has reshaped our capital and credit markets, enforcement efforts soared to new heights. Regulators and prosecutors redefined their enforcement priorities, commenced an unprecedented number of investigations and enforcement actions, and, according to a senior Securities and Exchange Commission (''SEC'' or ''Commission'') insider, reached out to and cooperated with domestic and foreign agencies in a manner that has not been seen in at least 30 years. Explaining the unusually intense scrutiny that regulators placed upon hedge funds in 2008, Bruce Karpati, who coordinates the SEC's Hedge Fund Working Group out of the New York Regional Office, suggested that, given the economic climate, ''half to two-thirds of hedge funds might go out of business''—and, as the aphorism goes, desperate times may lead hedge funds to take desperate measures. And these measures will continue to draw the SEC's attention under the Obama administration. At her confirmation hearing, Mary Schapiro, the new Chairman of the SEC, outlined an enforcement agenda for the new administration that would include much tighter regulation of hedge funds and their advisers.

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According to Linda Thomsen, then-Director of the SEC's Division of Enforcement, since 2000, the SEC has brought 145 actions involving hedge funds; and since 2003, the number of actions involving hedge funds each year has been in the teens or twenties. In 2008, that trend continued with the filing of 22 hedge-fund-related enforcement matters. In addition, the Department of Justice brought five hedge-fund-related criminal actions. While these numbers may seem unexceptional given the unprecedented scrutiny that hedge funds faced, the figures should be considered in light of the fact that 2008 saw: (a) the filing of a significant number of large, complex, or novel cases; (b) the culmination of similarly large, complex, or novel previously filed actions; and (c) the commencement of several broad industry-wide sweep investigations focusing on the activities of hedge funds and other market participants—all of which likely required the deployment of significant regulatory and prosecutorial resources. One need look no further than the highly publicized civil and criminal actions brought against Bernard L. Madoff for allegedly defrauding his advisory clients (hedge funds and others) out of billions of dollars in what might be

the largest financial fraud in history. Investor losses from the fraud could reach $50 billion.

Importantly, hedge fund enforcement activities in 2008 were part of a broader wave of general enforcement-related efforts that set new records. For example, in fiscal year 2008, the SEC reportedly brought the highest number of insider trading cases in the agency's history and a record high number of enforcement actions against market manipulation—including a precedent-setting case against a former hedge fund trader for spreading false rumors. Further, the SEC reportedly completed the highest number of enforcement investigations in any year to date, by far, and initiated the second highest number of enforcement actions in agency history. Adding to these records, then-SEC Chairman Christopher Cox noted that the Commission devoted more than one-third of the entire agency staff to the enforcement program—a higher percentage of the SEC's total staff than at any time in the past 20 years—and the internal allocation of funds for enforcement was the highest in agency history. More resources may be on the way. Citing their belief that financial crimes have soared because regulators are underfunded and understaffed, Senators Charles Schumer (D-N.Y.) and Richard Shelby (R-Ala.) recently introduced a bill—titled the Supplemental Anti-Fraud Enforcement (''SAFE'') Markets Act—that would add 500 FBI agents, 50 new Assistant U.S. Attorneys, and 100 extra officials at the SEC.

The level of interaction and cooperation among enforcement agencies in 2008 similarly rose to new heights. Thomas Biolsi, Associate Regional Director for Examinations at the SEC's New York Regional Office, recently observed that he has never seen—in 30 years—the type of multi-agency interaction now taking place. Not only are U.S. regulators increasingly working with each other in more sophisticated ways, they are also doing so with their foreign counterparts. According to then-Chairman Cox, ''[t]he Commission's international work was more significant in FY 2008 than ever before.'' During that time, the SEC reportedly made more than 550 requests of foreign regulators for assistance with SEC investigations—more than one a day on average, and far higher than any previous year—and cooperated with more than 450 requests from foreign regulators for enforcement assistance. A significant amount of this ''international work'' likely involved hedge funds. Indeed, Bruce Karpati recently stated that, given the ''global nature'' of the hedge fund industry and the fact that ''such a big component of what hedge funds do is in the overseas markets,'' the Hedge Fund Working Group is ''increasingly working with foreign regulators.''

The take-away is clear: hedge funds were under extraordinary regulatory scrutiny in 2008—particularly so once the economic crisis came to dominate the daily news—and that level of scrutiny is expected to continue, if not intensify, in 2009. In this article, we review those enforcement priorities that dominated the headlines in 2008 and look to remain at the forefront throughout 2009. Along the way, we also offer advice to hedge funds and their advisers about how to navigate the increasingly hostile regulatory landscape. Much of the information presented in this section is based on our review of cases filed and public sources describing enforcement initiatives and investigations. In addition, we have incorporated salient comments and observations made by senior regulators and prosecutors at a Nov. 24, 2008 Practising Law Institute Conference in New York on Hedge Fund Enforcement and Regulatory Concerns.

2. Hedge Fund Enforcement Priorities. Senior regulators and prosecutors from the SEC, the Financial Industry Regulatory Authority (''FINRA''), the New York Stock Exchange (''NYSE''), and the New York Attorney General's Office recently identified their top hedge fund enforcement priorities in 2008—all of which are expected to remain priorities in 2009. They were:

- Rumor mongering;
- Insider trading;
- Private investment in public equity (''PIPE'') transactions;
- Portfolio pumping;
- Valuation/Risk of investment;
- Allocation; and
- Predatory short selling and illegal short selling in connection with Regulation M.

B. Rumor Mongering: 'Thou Shalt Not Tell a Lie'

Rumor mongering—the act of knowingly creating, spreading, or using false or misleading information with the intent to manipulate securities prices—became a staple of the hedge fund enforcement vernacular in 2008. Bruce Karpati of the SEC's Hedge Fund Working Group explained why: ''from an enforcement and examination perspective, jittery markets . . . can be taken advantage of'' by false rumors, with particularly dangerous effects on our markets. Echoing this sentiment, David Markowitz, Chief of New York Attorney General Andrew Cuomo's Investor Protection Bureau, indicated that, in light of the financial market turmoil and economic crisis, short selling in conjunction with rumors became a hedge fund enforcement priority. Regulators have recognized that, in this economic climate, rumor mongering can lead to the precipitous collapse of even our most venerable institutions. Accordingly, 2008 saw unprecedented efforts to address this issue.

First, the SEC initiated nationwide enforcement investigations into alleged intentional manipulation of securities prices through rumor mongering and abusive short selling. In connection with these investigations, the SEC reportedly issued subpoenas to more than 50 hedge fund advisers and other participants in the securities markets, seeking various trading and communications data. Supplementing these investigations, the SEC, FINRA, and NYSE launched coordinated examinations of broker-dealers and investment advisers, including unregistered hedge fund managers, aimed at preventing the intentional spreading of false rumors to manipulate securities prices.

Only weeks later, the SEC announced a sweeping expansion of its ongoing investigations, stating that the Commission would require hedge fund managers and other investors with significant trading activity in financial issuers or positions in credit default swaps (''CDS'') to disclose those positions under oath pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934 (''Exchange Act''). According to Mr. Karpati, the expansion of the investigation to include CDS should not have come as a surprise. Mr. Karpati noted that it is appropriate to be ''very much focused'' on this area because

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false rumors can ''affect a company's credit quality,'' which in turn can affect trading in CDS. Shortly after its announcement, the SEC issued orders under Section 21(a)(1) to more than two dozen hedge funds and sell-side firms. The SEC's use of this tool—one that had not been broadly used for several years—represented a significant escalation of its enforcement efforts in this area. Notably, Linda Thomsen recently stated that, while she does not believe the SEC will use this tool ''every week,'' ''it's one more tool,'' and ''it's something [the SEC] will use in the future.'' The Commission has recently issued subpoenas out of various of its offices following up on the information it obtained through its Section 21(a) orders.

Enter the New York Attorney General's Office, which similarly launched a wide-ranging investigation into rumor mongering and short selling on Wall Street. Attorney General Andrew Cuomo has said he will use New York's Martin Act to prosecute any short sellers engaging in any improper conduct, including the spreading of false rumors. (The Martin Act empowers the Attorney General to investigate fraud in the purchase or sale of securities and to bring civil and criminal charges where appropriate.)

Following the trajectory of the SEC's investigation, David Markowitz recently stated that a ''new focus'' of the Attorney General's investigation is CDS. According to Mr. Markowitz, CDS ''contributed greatly to the economic situation we're facing today,'' and it is a ''ripe area for regulatory action'' or ''at least inquiry.'' As such, the office is taking a ''very comprehensive,'' ''broad-based look'' at CDS. In particular, the Investor Protection Bureau is looking at potential manipulation of the CDS market as a way of manipulating the equity market. And the Attorney General's Office is not working alone: it has partnered with the U.S. Attorney's Office in Manhattan—a partnership that signals just how comprehensive this investigation is. Thus far, the Attorney General's Office has sent subpoenas to multiple hedge funds in a wide range of locales, including New York, Texas, and London, among others.

Significantly, these ongoing investigations appear to be international in scope. Bruce Karpati recently observed that many rumors appear to come from overseas trading desks, and the SEC is increasingly working with foreign regulators to combat rumor mongering. The New York Attorney General's Office and the U.S. Attorney's Office in Manhattan may similarly be working with foreign authorities. Indeed, it is believed that Attorney General Cuomo partnered with federal prosecutors in recognition of the fact that a comprehensive investigation of these issues requires substantial coordination with foreign sources—a function that the U.S. Attorney's Office is particularly well suited to perform.

1. SEC v. Berliner. In April 2008, the SEC filed its first ever—and, to date, only—styled rumor mongering case—*SEC v. Berliner*—which was brought against a former trader with the Schottenfeld Group, a hedge fund. After the Blackstone Group had entered into an agreement to acquire Alliance Data Systems (''ADS'') for $81.75 per share, Paul S. Berliner allegedly disseminated a false rumor that read:

> ADS getting pounded—hearing the board is now meeting on a revised proposal from Blackstone to acquire the company at $70/share, down from $81.50. Blackstone is negotiating a lower price due to weakness in World Financial Network—part of ADS' Credit Services unit, as evidence [sic] by awful master trust data this month from the World Financial Network Holdings off-balance-sheet credit vehicle.

Berliner allegedly spread this false rumor through instant messages to 31 traders at hedge funds and brokerage firms. According to the complaint, Berliner profited by short selling ADS stock and covering those sales as the false rumor caused the price of ADS stock to fall.

If *Berliner* is the SEC's model for future rumor mongering cases . . . then a rumor's degree of specificity and falsity may also be a significant factor in whether the Commission brings an enforcement action.

The SEC brought an action in the U.S. District Court for the Southern District of New York, charging Berliner with securities fraud and market manipulation for intentionally disseminating a false rumor. Without admitting or denying the allegations in the complaint, Berliner agreed to settle the charges, and the court entered a judgment that (among other things) ordered him to disgorge $26,129 and pay a civil penalty of $130,000. The SEC separately barred him from associating with any broker or dealer. Commenting on *Berliner*, former Chairman Cox stated: ''The message of this case is simple and direct. The Commission will vigorously investigate and prosecute those who manipulate markets with this witch's brew of damaging rumors and short sales.''

2. A Moving Target, But a Target Nonetheless. While former Chairman Cox has acknowledged that it is difficult to pin down the source of market-moving rumors and to prove that rumors are ''knowingly false,'' these enforcement hurdles apparently have not deterred regulators from aiming their collective sights on rumor mongering. Shedding light on what may trigger a rumor mongering enforcement action by the Hedge Fund Working Group, Bruce Karpati said it ''comes down to knowledge'' and ''falsity of information.'' That is, did the individual have actual knowledge of the information's falsity? Or did he or she recklessly disregard the falsity of the information? Linda Thomsen suggested that contrived defenses such as, ''it's true that he or she told me [substance of rumor],'' would fall into this ''recklessness'' category and should not be attempted.

The *Berliner* case is also instructive. Notably, the rumor in *Berliner* was highly specific and completely (as opposed to partly) false. If *Berliner* is the SEC's model for future rumor mongering cases—and Bruce Karpati has suggested that it is—then a rumor's degree of specificity and falsity may also be a significant factor in whether the Commission brings an enforcement action.

For hedge funds that come under investigation for rumor mongering, if an assessment of these or other pertinent factors shows that a rumor mongering investigation or case is unfounded, Former Director Thomsen and Bruce Karpati stated that a presentation should be given to the SEC. According to Mr. Karpati, a presenta-

tion in a rumor mongering matter would be ''especially . . . beneficial.''

C. Insider Trading

Not only was insider trading by hedge funds an enforcement priority in 2008, but, according to Linda Thomsen, it was an issue on which the Hedge Fund Working Group (and other regulators) put a ''particular emphasis.'' Director Thomsen elaborated: ''It is clear that there is a widespread public perception of insider trading by hedge funds ahead of the public announcement of significant corporate transactions. This perception, in and of itself, is harmful to the reputation of our markets for fairness and integrity and therefore warranted further investigation—which has been undertaken by our Hedge Fund Working Group.''

Two areas of focus that have emerged in connection with insider trading are CDS and PIPE transactions. Bruce Karpati has said that CDS are ''ripe for insider trading'' because they can be used to ''bet on the future outlook of companies''; accordingly, the Hedge Fund Working Group has recognized CDS as a priority. So, too, has the New York Attorney General's Office, in partnership with the U.S. Attorney's Office in Manhattan. It should be noted that, as with the rumor mongering enforcement efforts discussed above, the SEC, the New York Attorney General's Office, and the U.S. Attorney's Office appear to be working with foreign regulators to combat insider trading in increasingly vigorous ways. The SEC has also brought insider trading cases in connection with PIPE transactions; however, because regulators have identified PIPE transactions as a standalone priority, we discuss this topic separately below.

Apart from these specific focus areas, regulators and prosecutors have continued to name hedge funds and persons associated with them in more traditional insider trading cases.

1. The Mitchel S. Guttenberg Matter. Perhaps most significantly, a number of developments occurred in connection with *SEC v. Guttenberg*—billed as the most significant insider trading case since the late 1980s. Alleging two insider trading schemes involving several hedge funds and over $15 million in illicit profits, the SEC brought this civil enforcement action against 14 defendants in the so-called Wall Street Insider Trading Ring. As part of the scheme, the SEC alleged that Mitchel S. Guttenberg, an executive director in the equity research department of UBS and one of the key participants in the scheme, illegally passed inside information regarding upcoming UBS research reports to others, including Erik R. Franklin, in exchange for sharing in the illicit profits from their trading on that information. Franklin allegedly used the information to make trades for the two hedge funds that he managed. The SEC also alleged that Randi E. Collotta, an attorney who worked in the global compliance department of Morgan Stanley, passed inside information regarding the upcoming corporate acquisitions of Morgan Stanley's investment banking clients to Marc R. Jurman, a registered representative, in exchange for sharing in Jurman's profits from trading on that information. The complaint further alleged that Jurman illegally traded on this inside information and passed the information to several downstream tippees who also traded on it, both for themselves and for hedge funds under their management.

In September 2008, a number of the defendants settled the SEC's insider trading charges. These defendants were permanently enjoined from violating the federal securities laws and ordered to pay various disgorgement amounts ranging from $4,500 to approximately $2.7 million. Many of them were also barred from associating with any broker, dealer, or investment adviser. With respect to Collotta, the SEC separately issued an order suspending her from appearing or practicing before the Commission as an attorney.

Also, in November 2008, in connection with the parallel criminal case brought by the U.S. Attorney's Office for the Southern District of New York, Guttenberg was sentenced to six-and-a-half years in prison after pleading guilty to six counts of conspiracy and securities fraud.

2. Efforts by Foreign Regulators to Combat Insider Trading

a. The Steven Harrison Matter. U.S. regulators were joined by their foreign counterparts in taking unprecedented action to combat insider trading. In September 2008, a settlement was reached in what the U.K. Financial Services Authority (''FSA'') has called its first ever credit market abuse case. The FSA alleged that Steven Harrison, a former hedge fund manager at Moore Europe Capital Management, was provided with inside information about the refinancing plans of Rhodia, which he illicitly passed onto a colleague with instructions to buy. Under the settlement, Harrison agreed not to act as a fund manager or trader for 12 months and to pay a $92,500 fine. In setting this penalty, the FSA considered several notable factors. The FSA found that Harrison's conduct was not deliberate, he made no direct personal profit from these activities, and he cooperated with the FSA's investigation. The FSA also took into account the impact of the 12-month restriction to which Harrison agreed. Significantly, the FSA sanctioned the former hedge fund manager even though it apparently could not prove that he knew he possessed inside information when trading took place and even though he did not appear to profit from the trades.

b. The Porsche Matter. In October 2008, Germany's financial regulator, BaFin, announced that it will investigate whether the dramatic price moves seen in Volkswagen's share price were due to market manipulation in general or insider dealing in particular. As reported in the press, Volkswagen's share price more than quadrupled after it was revealed that Porsche had built up a much larger stake in Volkswagen than had previously been thought. This reportedly caused hedge funds that believed its price would fall to close out their short positions and scramble to buy up the small amount of free-float shares available. As a result, news reports noted, Volkswagen's share price surged, briefly making it the world's largest company by market capitalization. Shortly thereafter, its price fell dramatically, reportedly losing 45 percent on October 29, 2008. BaFin has not yet identified any targets of its investigation.

3. Internal Controls a Must. In addition to being an enforcement priority, insider trading by hedge funds is a key examination priority. The SEC has said it will focus on ''the adequacy of policies and procedures, information barriers, and controls to prevent insider trading and leakage of information including the identification of sources of material non-public information, surveil-

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lance, physical separation, and written procedures.'' Thomas Biolsi of the SEC recently emphasized that, in addition to these factors, he and his team will check to see whether a company has a code of ethics, and whether the policies and procedures in place are actually being followed. Thus, hedge funds wishing to minimize the likelihood of enforcement scrutiny should review carefully their insider trading policies and procedures, paying particular attention to these express focus areas.

D. PIPE Transactions. For the past few years, the SEC has focused significant attention on the use of shares acquired in PIPE offerings to cover short sales of the publicly traded stock, and SEC officials have made clear that PIPE transactions will remain a hedge fund enforcement priority going forward.

In a PIPE offering, a public company issues unregistered securities to private investors, including hedge funds. The public company commits to investors that, within a short time following their investment, it will file a registration statement and register the shares that were sold in the PIPE with the SEC. When the issuance of restricted shares in a PIPE offering is publicly announced, the price of the PIPE issuer's publicly traded stock typically declines. Given this dynamic, PIPE investors often attempt to reduce their risk by selling short the PIPE issuer's publicly traded securities. To cover their short positions, certain investors choose to wait until the SEC declares a PIPE resale registration statement effective and then use their previously restricted PIPE shares to close out their short positions.

The SEC has argued this strategy violates the federal securities laws in two ways. First, the SEC has claimed that these short sales constitute insider trading violations. According to this theory, the public announcement of a PIPE offering will cause a decline in the market price of the issuer's publicly traded stock, enabling the investor to profit wrongfully from confidential, preannouncement information about the PIPE offering. Second, when investors cover their pre-effective date short positions with the actual shares received in the PIPE, the SEC has claimed that investors have engaged in the sale of unregistered securities in violation of Section 5 of the Securities Act. This contention is based on the view that shares used to cover a short position are deemed to have been sold when the short sale was made (*i.e.*, when they were still unregistered).

1. The Commission's Section 5 Theory: Down, But (Maybe) Not Out. In January 2008, two federal district courts weighed in on the SEC's legal theories. Both courts ruled that the SEC's insider trading theory constituted a plausible legal basis upon which the SEC could continue to litigate its case. But the SEC's Section 5 theory met a different fate, with both courts rejecting and dismissing the theory as legally deficient. In a subsequent action, the SEC advanced only its insider trading theory. Notwithstanding these adverse rulings and the SEC's recent decision to press only its insider trading theory, the SEC has indicated that it does not plan to abandon its Section 5 theory.

a. SEC v. Lyon. In *SEC v. Lyon*, the Commission filed an enforcement action in the U.S. District Court for the Southern District of New York against Edwin Buchanan Lyon, a hedge fund manager, and seven hedge funds for short sales involving 35 PIPE offerings. The SEC brought insider trading claims and a Section 5 claim. In a January 2008 opinion, the court declined to dismiss the SEC's insider trading claims but rejected as ''logical[ly] implausibl[e]'' the SEC's Section 5 theory that the defendants caused an unregistered distribution of securities when they covered their short sales with shares purchased in the PIPE offerings. According to the court, this position is ''inaccurate and not reflective of what occurs in the market.'' The court concluded that ''a short sale of a security constitutes a sale of that security'' and ''[h]ow an investor subsequently chooses to satisfy the corresponding deficit in his trading account does not alter the nature of that sale.''

b. SEC v. Berlacher. In *SEC v. Berlacher*, the SEC filed suit in the U.S. District Court for the Eastern District of Pennsylvania against a hedge fund operator, Robert A. Berlacher, and his group of funds, known as the Lancaster Funds. The allegations in *Berlacher* materially reflect those in *Lyon*, and the SEC likewise advanced its insider trading and Section 5 theories. The court in *Berlacher*, following *Lyon*'s reasoning, similarly allowed the SEC's insider trading claims to proceed but dismissed its Section 5 claim.

c. SEC v. Ladin. In October 2008—following these adverse rulings on the SEC's Section 5 theory—the Commission filed a settled enforcement action in the U.S. District Court for the District of Columbia, charging Brian D. Ladin, a former analyst for Bonanza Master Fund, a Dallas-based hedge fund, with improper PIPE-related trading. The allegations are similar to those in *Lyon* and *Berlacher*, yet the SEC alleged only that Ladin engaged in unlawful insider trading in connection with a 2004 PIPE offering.

2. If at First You Don't Succeed . . . . Including *SEC v. Mangan*—a 2007 case that fits the mold of *Lyon* and *Berlacher*—the SEC's Section 5 theory has seen defeat in three different federal district courts. Given this adverse case law, former Director Thomsen recently conceded that the SEC's Section 5 theory is ''not doing well in the courts.'' Director Thomsen quickly added, however, that the Commission's insider trading theories ''still work.'' Consistent with that assessment, the SEC in *Ladin* appeared to advance only its insider trading theory. Recently, however, the SEC has signaled that it does not plan to give up on its Section 5 theory, though the Commission did not specify what it intends to do or when it intends to act. The SEC could appeal the dismissal of its Section 5 claim once its insider trading claims are resolved in the ongoing *Mangan*, *Lyon*, or *Berlacher* litigation. The SEC could also issue clarification or guidance on this issue. What *is* clear, however, is that regulators will continue to scrutinize hedge funds' trading practices in PIPE offerings, and hedge funds therefore should be particularly attentive to the substantial risks that are presented by the conduct at issue in these cases.

3. The Hilary L. Shane Matter—Use of a Deferred Prosecution Agreement. Although the federal litigation involving the SEC's insider trading and Section 5 theories received much attention in 2008, a less noticed but significant development occurred in August 2008 when the U.S. Attorney's Office for the Southern District of New York struck a deferred prosecution deal with Hilary L. Shane, a former hedge fund manager, who had been indicted in 2006 on five counts of insider trading in con-

nection with a PIPE transaction. This appears to be the first use of a deferred prosecution agreement in the PIPE context. The criminal case stemmed from a settled SEC civil action against Shane for entering into short sales, both for herself and the hedge fund she managed, while also taking part in a PIPE offering. Under the terms of the agreement, Shane must (among other things) refrain from associating with an investment adviser and pay a $50,000 fine. If Shane complies, the government is expected to dismiss her 2006 indictment on insider trading charges. Shane, who had pleaded not guilty, had faced up to 100 years in prison if convicted on all five counts.

E. Portfolio Pumping

According to Bruce Karpati, the Hedge Fund Working Group has focused on attempts by hedge fund personnel to ''inflat[e] performance during a desperate situation.'' In particular, the SEC has brought enforcement actions based on portfolio pumping or ''marking the close''—where a hedge fund buys large quantities of thinly traded securities to boost fund asset values at the end of a reporting period. In 2008, portfolio pumping firmly established itself as a priority on the SEC's hedge fund enforcement agenda based on the view (articulated by Lori Richards, Director of the SEC's Office of Compliance Inspections and Examinations) that, ''in times of financial strain, people may act in uncharacteristic ways—in order to conceal losses, [or] inflate revenues or profits, to stay in business or just to avoid delivering bad news.'' The following two cases are illustrative.

1. SEC v. Lauer. In September 2008, a federal district judge in Florida granted the SEC's motion for summary judgment against the architect of a massive billion dollar hedge fund fraud involving portfolio pumping. According to the SEC's complaint, Michael Lauer lied about the performance and net asset value of three hedge funds that he created. As alleged in the complaint, Lauer systematically manipulated the month-end closing prices of certain securities held by the funds to overstate the value of their holdings in virtually worthless companies. For example, in December 2002, at the end of the last trading day of the year, Lauer allegedly placed two orders for Fidelity First stock, which artificially raised the price of the stock to $5.00 a share. Lauer then valued all of the funds' Fidelity First stock holdings at $5.00 per share. Among other things, the summary judgment order found that Lauer manipulated the prices of several securities and materially overstated the hedge funds' valuations for a number of years. The court permanently enjoined Lauer from future violations of the federal securities laws but reserved ruling on the SEC's claim for disgorgement and similar matters. The Commission is seeking disgorgement and penalties totaling more than $50 million.

Earlier, the U.S. Attorney's Office for the Southern District of Florida indicted Lauer on one count of conspiracy to commit mail, wire, and securities fraud and six counts of wire fraud. If convicted, Lauer reportedly could face a maximum sentence of 20 years and a $250,000 fine for each count of wire fraud, and five years and a $250,000 fine for the conspiracy count.

2. The MedCap Matter. In October 2008, the SEC charged San Francisco investment adviser MedCap Management & Research (''MMR'') and its principal, Charles Frederick Toney, Jr., with reporting misleading results to hedge fund investors by engaging in portfolio pumping. Toney, through MMR, is the manager of MedCap Partners (''MedCap''), a hedge fund that reportedly suffered dramatic losses throughout 2006. In an effort to report favorable news to the fund's investors, Toney—through a separate fund he managed—allegedly placed large orders for a thinly traded stock in which MedCap was heavily invested. According to the administrative complaint, because the stock represented over a third of MedCap's holdings, the brief boost in its price inflated the reported value of the MedCap fund from approximately $9 million to $38 million. Toney allegedly reported to MedCap's investors that the fund's performance was improving without disclosing the reason for this bounce. Without admitting or denying the Commission's findings, MMR and Toney agreed to cease and desist from violating the federal securities laws. MMR disgorged $70,633.69 and received a Commission censure. Toney was also ordered to pay a $100,000 penalty and was barred from associating with any investment adviser, with the right to reapply after one year.

3. A Clear Priority Going Forward. Given the heightened regulatory concern that portfolio managers may engage in portfolio pumping to boost fund performance or enhance their fees, we expect the SEC to bring a larger wave of actions similar to the *Lauer* and *MedCap* matters in 2009. Accordingly, hedge fund advisers and principals should ensure that their funds have in place policies that specifically identify portfolio pumping as a concern and clearly prohibit it. In addition, hedge funds should ensure that they have systems in place to capture and evaluate trading data that could be construed to constitute portfolio pumping.

F. Valuation/Risk of Investment

According to Bruce Karpati, another enforcement priority for the Hedge Fund Working Group is valuation, with a particular focus on how the risk of underlying investments is disclosed to investors. Mr. Karpati indicated that the ''trend'' is to look for instances where ''hedge fund managers l[ie] about value.'' Linda Thomsen and Mr. Karpati recently suggested that the following matters illustrate the kinds of cases that the SEC is looking to bring in this area.

1. SEC v. Lauer. As discussed above, in September 2008, a Florida federal court granted the SEC's motion for summary judgment against Michael Lauer. The SEC alleged, among other things, that Lauer lied about the net asset value of three hedge funds that he created and provided unfounded and unrealistic valuation opinions to the auditor of one of the funds. Lauer's groundless valuations were allegedly designed to attract new investors to invest and induce actual investors to forgo redemptions and continue investing in the funds—with the objective of generating increased management fees. The summary judgment order found that Lauer materially overstated the hedge funds' valuations for a number of years and failed to provide any basis to substantiate or explain his exorbitant valuations. The order permanently enjoined Lauer from future violations of the

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federal securities laws. The SEC's claim for disgorgement and penalties remains pending, as do criminal charges brought earlier in the year by the U.S. Attorney's Office for the Southern District of Florida.

2. In the Matter of Don Warner Reinhard. In October 2008, the SEC initiated administrative proceedings against Don Warner Reinhard, the sole owner and president of Magnolia Capital Advisors, a registered investment adviser, charging Reinhard with making false and misleading statements and omissions of material fact to investors in connection with the offer and sale of collateralized mortgage obligations. According to the SEC's complaint, Reinhard misrepresented the investment risk associated with the mortgage obligations that he purchased for his clients and for Magnolia Capital Partners, a hedge fund he controlled. The complaint also alleges that Reinhard provided clients with false quarterly account statements that materially inflated their account valuations. The action is currently pending.

3. By the Numbers. Not only is valuation an enforcement priority, it is also an examination priority. Lori Richards has said this is an ''important area,'' and she and Thomas Biolsi recently made clear that SEC examiners will continue to focus on firms' valuation controls. Hedge funds should therefore take proactive measures in this area, including (among other things):

- Ensuring that their valuation policies and procedures are well designed and effective;
- Confirming that the individuals involved in valuing products have the requisite seniority and expertise; and
- Verifying that the process used to value products is marked by independence and objectivity.

G. Allocation

Bruce Karpati recently stated that ''favoritism in allocations'' is an enforcement priority of the Hedge Fund Working Group. With respect to this issue, Mr. Karpati indicated that the SEC is focused on the following questions: ''How are investors treated?'' ''Are hedge fund principals given an advantage over other hedge fund investors?'' ''Is preferred status given?'' Mr. Karpati added that, at bottom, allocation ''is a matter of disclosure.''

1. SEC v. Dawson. In September 2008, the SEC filed a complaint in the U.S. District Court for the Southern District of New York against James C. Dawson, an investment adviser to a hedge fund, Victoria Investors, and to individual clients. The Commission's complaint alleges that Dawson cherry-picked profitable trades for his own account, thereby harming his clients and unjustly enriching himself at their expense. Dawson allegedly conducted this scheme by purchasing securities throughout the day in a single account and delaying the allocation of the purchases until later in the day, after he saw whether the securities appreciated in value. According to the complaint, Dawson allocated approximately 400 trades to his personal account, approximately 393 of which were profitable on the first day, for a success rate of approximately 98 percent; in contrast, of the 2,880 trades Dawson allocated to his clients during the same time, only 1,489 were profitable on the first day, for a success rate of approximately 52 percent. Dawson allegedly did not tell Victoria Investors or his individual clients about this allocation process. The complaint further alleges that Dawson used his hedge fund clients' assets to pay for personal expenses without the clients' knowledge. Among other things, the Commission is seeking disgorgement and an order permanently enjoining Dawson from violations of the federal securities laws.

2. Spread the Wealth. Although only one allocation case appears to have been brought in 2008, investigations may very well be underway. Equally important, fund allocation is an examination priority. Calling this a ''focus area,'' Lori Richards has indicated that ''[e]xaminers are looking for cherry-picking and favoritism in allocations to, for example, relatives, high profile clients, clients with performance-fee accounts, or other clients that the adviser may have an incentive to benefit.''

Accordingly, hedge fund advisers are encouraged to review their fund allocation policies and procedures to ensure that the full range of potential conflicts is addressed. Among other things, advisers should also confirm that those policies and procedures are designed to ensure—and actually produce—equitable allocation among different funds and managed accounts.

I. Conclusion

At this time, the hedge fund enforcement landscape appears relatively clear. Regulators and prosecutors have been transparent in identifying their priorities. Still, there are questions concerning the specific ways in which regulators will move forward in pursuing them. For example, will regulators bring rumor mongering cases with facts that are less compelling than those in *Berliner*—perhaps one where the rumor at issue is general or vague? And what tools will the SEC develop to ferret out false rumors? Will the SEC in fact reinvigorate its Section 5 PIPE theory? If so, what specific form will the Commission's efforts take? Questions abide. In navigating these and similar issues, regulators will need to ensure that the specific enforcement positions they take do not unduly chill appropriate and important hedge fund (and other) activities that constitute a key component to the sound and efficient functioning of our securities markets. And while regulators' enforcement priorities seem clear now, those priorities can change suddenly and dramatically. Consider the Bernard L. Madoff scandal. In December 2008, the SEC and the U.S. Attorney's Office in Manhattan brought concurrent civil and criminal actions against Madoff and his investment firm, Bernard L. Madoff Investment Securities LLC, charging Madoff with orchestrating a Ponzi scheme through which he defrauded his hedge fund clients and other investors out of billions of dollars. In February 2009, Madoff entered into a partial settlement with the SEC. Under the terms of the agreement, Madoff agreed to a permanent injunction and stipulated that, for purposes of determining disgorgement and monetary penalties, he will not dispute the SEC's charges against him.

For years, Madoff's scheme apparently escaped the attention of regulators, including the SEC and FINRA. The SEC has come under fire for not uncovering the Madoff scandal until his sons went to authorities and told them he had confessed to the fraud. Indeed, on January 5, 2009, the House Committee on Financial

Services held a hearing to examine how a scheme of this magnitude could have gone undetected for so long, whether the SEC has the resources to police the markets effectively, and what new safeguards may be needed to protect investors. From an enforcement and examination perspective, the fallout from the Madoff scheme and regulators' failure to detect it will almost certainly cause the Commission to step up and revamp its examination of investment advisers and oversight of those that are unregistered. Indeed, Chairman Schapiro has stated her intention to ''take the handcuffs off the Enforcement Division'' and has already begun to consult with intelligence and law enforcement agencies to develop new techniques for combating financial fraud. Moreover, Linda Thomsen recently resigned from her position as Director of Enforcement, and there is every reason to believe that Chairman Schapiro will tap her successor, Robert Khuzami, to turn up the regulatory heat across financial sectors. Thus, there are early indications that hedge funds will remain in the crosshairs throughout 2009.

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