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WHITE-COLLAR CRIME

BY ROBERT G. MORVILLO AND ROBERT J. ANELLO

Regulation and Prosecution of Hedge Funds

Press and media attention devoted to hedge funds might make the public believe that hedge funds represent the lawless Wild West of the securities industry in desperate need of regulation.

A recent Court of Appeals decision has thwarted the Securities and Exchange Commission's (SEC) efforts to regulate some of these investment entities that traditionally were intended for the most sophisticated investors—savvy enough to fend for themselves. Congressional hearings currently under way are examining the proper role of government in overseeing the activity of these funds.

This recent attention and debate should not overshadow the fact that the majority of such funds are professionally and ethically administered—adhering to the highest standards demanded by their wealthy individual and institutional investors. Indeed, many of the larger and better-known funds included by the public within the "hedge fund" terminology are subject to all the regulations applicable to investment advisers under the Investment Adviser Act of 1940. Nor should the fact be ignored that when they run afoul of the law, unregulated hedge funds and their managers have been prosecuted by plethora statutes that thoroughly cover the full array of mischief that may occur when investing other people's money.

The Nature of Hedge Funds

Hedge funds are defined by the SEC as "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public."[1] Typically, hedge fund managers advise the fund for a fixed fee and percentage of gross profits, while the investors remain passive and play little to no part in the fund's management activities.[2] Hedge funds currently represent only 5 percent of the total assets under management in the United States ($1.2 trillion versus $9.2 trillion invested in mutual funds), however, they account for approximately 30 percent of all trades in the United States' stock exchanges. As a result, they have a significant impact on the nation's securities markets.[3]

Robert G. Morvillo *and* **Robert J. Anello** *are partners at Morvillo, Abramowitz, Grand, Iason, Anello & Bohrer.* **Gretchan R. Ohlig,** *an attorney, assisted in the preparation of this article.*

Robert G. Morvillo *Robert J. Anello*

Hedge funds can avoid the requirements of the Securities Act of 1933, which regulates the offering and distribution of securities sold to the public, by using the private placement exemption set forth in §4(2) and Rule 506 of Regulation D.[4] Similarly, hedge funds frequently are exempt from the requirements of the Securities Exchange Act of 1934, which covers all transactions involving securities. Hedge funds and their advisers typically are exempt from the regulations set forth in the Investment Company Act of 1940 and the Advisers Act as well.[5] Exemption from the requirements of these statutes is due to the unique structure of hedge funds and the sophistication of their investors.

The Securities Act exemption was created "to apply to particular or isolated sales or offerings to a few or limited securities holders where the public interest is not strongly implicated."[6] Hedge fund managers are not considered broker-dealers under the Exchange Act because they do not "engage[] in the business of effecting transactions in securities for the accounts of others," but engage in transactions for their own accounts, and therefore are considered "traders" instead of broker-dealers.[7] Exemption from the Investment Company Act comes about because hedge funds either have one hundred or fewer beneficial owners and do not offer their securities to the public or because their investors qualify as "high net-worth individuals or institutions."[8] Finally, hedge fund advisers often are exempt from the registration requirements of the Advisers Act, qualifying for the "private adviser" exception set forth in §203(b)(3). This exception exempts an investment adviser who satisfies three requirements: (i) has had fewer than 15 clients during the preceding 12 months; (ii) does not advise registered investment funds; and (iii) does not hold itself out generally to the public as an investment adviser.[9]

While a listing of these exemptions initially may create the impression that hedge funds and their managers can operate on their own accord, the reality is much different. First, many hedge fund advisers voluntarily have registered with the SEC in accordance with the requirements of the Advisers Act. In fact, the SEC currently has registered more than 2,500 hedge fund advisers. Once registered, advisers are required to maintain certain books

and records and generally are prohibited from receiving performance-based compensation. Increase in the voluntary registration of hedge fund advisers has been attributed to: (i) the fact that many institutional investors will not invest in a hedge fund unless the adviser is registered and (ii) hedge fund managers' use of Adviser Act registration in a fund's advertising and marketing materials created an inference of the fund's "bona fides."[10]

Prosecutions and Enforcement Actions

Increased pressure to regulate hedge funds may be traced back to the spectacular near-collapse of Long Term Capital Management in 1998. Long Term Capital was an enormous hedge fund which suffered substantial losses in the summer of 1998, threatening the stability of American markets in the process. To prevent this potentially devastating impact, Long Term Capital's creditors and banking regulators created a consortium to inject equity into and stabilize the hedge fund's position. This near-collapse caused federal legislators and those in the financial industry to take a closer look at the role hedge funds play in the nation's economy.[11]

Despite statutory exemptions, hedge funds remain subject to all of the antifraud provisions of the federal securities laws. This includes Rule 10b-5 of the Exchange Act, §17(a) of the Securities Act, and §206 of the Advisers Act. As for the latter of these provisions, even when a hedge fund adviser is exempt from the Advisers Act's registration requirements, it is nevertheless subject to the Advisers Act's antifraud provisions. The primary antifraud provision set forth in §206 of the Advisers Act makes it unlawful for an investment adviser to directly or indirectly engage in a number of fraudulent or deceptive practices. Section 206 is broad in its application. Unlike Rule 10b-5 of the Exchange Act, actions brought pursuant to the Advisers Act's antifraud provisions are not limited to situations involving the purchase or sale of a security and may not require proof of scienter (i.e., intent or recklessness). In fact, "the expansive language of Section 206—and the broad SEC interpretations of it—provide the SEC with maximum freedom in attacking abusive practices by fund managers."[12]

The SEC has not hesitated in bringing enforcement actions against hedge funds on these bases. In its 2003 Staff Report, the SEC noted that since 1999, the commission has seen a steady increase in enforcement actions against hedge funds, their advisers, and their principals, the overwhelming majority of which involved charges under the federal securities statutes. Although the SEC acknowledged that "[t]here is no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity," the growing number of enforcement actions was attributed to the SEC's perception of an increase in the popularity of hedge fund investments, entrance to the industry of inexperienced and unqualified individuals, and a lack of adequate controls on the operation of some hedge fund advisers. Finally, the SEC Staff Report stated that the types of fraud charges brought against hedge fund advisers was similar to the types of fraud charged against other types of investment advisers, including misappropriation of assets and misrepresentation or falsification of material information.[13]

The SEC frequently has sued hedge funds and their managers for classic securities violations such as insider trading, stock manipulation, and fraud. As an example, in March of this year, the SEC filed and settled charges against New York-based hedge fund manager, Jeffrey Thorp, and three funds he managed, Langley Partners LP, North Olmsted Partners LP, and Quantico Partners LP. Although Mr. Thorp and the funds settled without admitting or denying wrongdoing, they were charged with engaging in a deceptive trading strategy involving insider trading, unregistered stock transactions and "naked" short sales. In settlement of these allegations, Mr. Thorp and the funds agreed to pay $15.8 million in disgorgement and penalty amounts. The irony of this case is the fact that Thorp is the son of Edward Thorp, the founder of the first successful, well-known hedge funds, Princeton/Newport. In 1989, regulators alleged that Princeton/Newport had engaged in insider trading, causing the fund to close the following year.[14] These cases demonstrate that hedge funds are not immune to regulatory action by the SEC.

Hedge funds also have been subject to charges by state governments and self-regulatory organizations such as the National Association of Securities Dealers Inc. (NASD). New York Attorney General Eliot Spitzer has relied on the Martin Act, a 1921 state business statute, to allege and prosecute fraudulent trading arrangements between a hedge fund, Canary Capital Partners, and mutual fund companies.[15]

Finally, hedge funds also face the threat of federal criminal prosecution. In 1999, Martin Armstrong, the manager and chairman of an off-shore hedge fund, Princeton Economics International Ltd., was indicted for securities fraud in the Southern District of New York for selling $3 billion in promissory "Princeton Notes" to Japanese entities, investing the proceeds in risky currency and commodities transactions, racking up huge losses and then concealing those losses from investors.[16] In 2003, a consultant to the Lancer Group hedge funds pleaded guilty to conspiring to commit securities fraud and participating in a plan to manipulate the price of a stock owned by the Lancer fund.[17] In that same year, Burton Friedlander, who oversaw the Connecticut-based hedge fund Friedlander International Ltd., was indicted on allegations that he used investors' money for business and personal expenses.[18] These are but a few of many criminal prosecutions brought against hedge funds.

'Goldstein v. SEC'

Apparently not content with oversight available through enforcement actions, the SEC recently attempted to broaden its control over hedge funds by amending its interpretation of certain provisions of the Advisers Act to require more hedge fund managers to comply with its requirements. Traditionally, hedge fund advisers qualified for the "private adviser exemption" from the statute's requirements which, among other things, exempts advisers with "fewer than 15 clients."[19] Until 2004, the SEC applied the Safe Harbor Rule which defined hedge fund limited partnerships or funds as a single "client." Accordingly, even large hedge fund managers were exempt.

After contentious debate, the SEC voted 3-2 to amend the Safe Harbor Rule by adopting the Hedge Fund Rule which expands the definition of "client" to include "the shareholder[], limited partner[], member[], or beneficiar[y]…of [the] fund," a change which the court noted had the effect of requiring most hedge fund advisers to register under the act.[20] In justifying this change and the resulting push for increased regulation of hedge funds, the SEC identified three "recent shifts" in the hedge fund industry: (i) the tremendous increase in hedge fund assets from 1999 to 2004; (ii) a trend toward "retailization" of hedge funds resulting in increased exposure of ordinary investors to such funds; and (iii) the SEC's concern about the increased number of fraud actions brought against hedge funds.[21]

In *Goldstein v. Securities Exchange Commission*, the U.S. Court of Appeals for the District of Columbia Circuit examined the validity of the SEC's interpretation.[22] Specifically, the court reviewed the Hedge Fund Rule and its alteration of the Safe Harbor Rule as applied to hedge funds. The *Goldstein* court found the SEC's rule change arbitrary and contrary to the purpose and

policy of the Advisers Act and specifically found evidence of the supposed "recent shifts" in the hedge fund industry to be lacking.[23] Accordingly, the court vacated the SEC's rule.

Congressional Hearings

Congress too has shown an increased interest in the business of hedge funds. Last month when the Senate Judiciary Committee held hearings on the issue of hedge funds and their relationships with independent analysts, the broader topic of hedge fund regulation was addressed. The issue was broached most directly by former SEC lawyer, Gary J. Aguirre, when he stated: "The subject of your committee's hearing today ("Hedge Funds and Independent Analysts: How Independent Are Their Relationships?") is the most recent variant of a stubborn question that keeps popping up at Senate committee hearings: Is federal law enforcement adequately protecting the nation's capital markets and their participants from the risk of manipulation and fraud by the nation's 11,500 hedge funds? The answer is no." Although Mr. Aguirre used the forum in part to address what he believes was his retaliatory firing by the SEC, he also set forth his belief that the SEC has failed to police hedge funds aggressively.[24]

Connecticut Attorney General Richard Blumenthal also testified before the committee, urging Congress to further regulate hedge funds, stating that the *Goldstein* opinion left hedge funds in "a regulatory black hole—lacking even minimal disclosure and accountability required of mutual funds and other similar institutions." He said that "either Congress or the SEC must act quickly to fill the void and assure confidence in the integrity of the markets and the hedge funds," stating his belief that Congress' first step should be equalizing the regulation of hedge funds with the type imposed on mutual funds.[25]

In contrast, the committee heard testimony from Joseph McLaughlin from the Managed Funds Association (MFA), the largest and most diverse U.S.-based association representing the hedge fund industry, touting the benefits of hedge funds. He testified that "[h]edge funds enhance market liquidity and contribute to pricing efficiency and market stability… [and] foster financial innovation and risk sophistication among the market participants with which they deal." Accordingly, the MFA encouraged Congress to work with the hedge fund industry to preserve these benefits while discouraging increased regulation of the business of hedge funds.[26]

Whatever Congress' findings, the distinctive business of hedge funds proves difficult to regulate. As former Federal Reserve Chairman Alan Greenspan told Congress in 1998, "Given the amazing communication capabilities available virtually around the globe, trades can be initiated from almost any location. Indeed, most hedge funds are only a short step from cyberspace. Any direct U.S. regulations restricting their flexibility will doubtless induce the more aggressive funds to emigrate from under [United States] jurisdiction. The best we can do, in my judgment, is do what we do today: Regulate them indirectly…."[27] Noting that the SEC's focus should be on protecting the small investor, New York Attorney General Eliot Spitzer has expressed his view that "hedge funds should be a low priority for the SEC."[28]

Whatever the outcome of these hearings and the applicability of the registration or disclosure requirements of federal securities laws, hedge funds and their managers remain liable for fraudulent activities. No clear evidence exists that further regulation is necessary to prevent such fraud or that the sophisticated investors of hedge funds are at risk. By the SEC's own admission, "the instances of fraud within the hedge fund market are disproportionately low to the instances of fraud within the investment industry generally." Furthermore, the majority of fraud actions brought against hedge funds would not have been prevented had the advisers or the funds themselves been registered with the SEC.[29] Given these admissions by the SEC, further regulation by either Congress or the SEC may be politically valuable, but of little real benefit.

1. Staff Report to the United States Securities and Exchange Commission, "Implications of the Growth of Hedge Funds" (September 2003) ("SEC Staff Report") at p. 3 (available at http://www.sec.gov/news/studies/hedgefunds0903.pdf).

2. Id. at pp. 9-10.

3. Walt Bogdanich and Gretchen Morgenson, "SEC is Reported to be Examining a Big Hedge Fund," The New York Times (June 23, 2006).

4. See Willa E. Gibson, "Is Hedge Fund Regulation Necessary?" Temple Law Review (Summer 2000) (detailing hedge funds' exemptions from federal securities statutes); Joseph Hellrung, "Hedge Fund Regulation: Investors Are Knocking at the Door, But Can the SEC Clean House Before Everyone Rushes In?" North Carolina Banking Institute (April 2005)(same).

5. Id.

6. 15 USC §80a-1, 80a-3(a)(1)(A).

7. Id.

8. Id. at §§80a-3(c)(1), (c)(7).

9. 15 U.S.C. § 80b-1, et seq.

10. See Joseph C. Long, "A Hedge Fund Primer," Securities Arbitration 2005: Telling Your Story, Practicing Law Institute, Corporate Law and Practice Course Handbook Series (August 2005); Kara Scannell, "Some Hedge Funds Pull SEC Registration Plans," Wall Street Journal (July 20, 2006).

11. Willa E. Gibson, "Is Hedge Fund Regulation Necessary?" Temple Law Review (Summer 2000).

12. Gerald T. Lins, Thomas P. Lemke, Kathryn L. Hoenig and Patricia Schoor Rube, "Hedge Funds and Other Private Funds: Regulations and Compliance" §3:16 (May 2006).

13. See SEC Staff Report at pp. 72-74.

14. See SEC Litigation Release No. 19607, 2006 WL 623053 (March 14, 2006); Kara Scannell, "Three New York Hedge Funds Settle Charges Tied to Trading," Wall Street Journal (March 15, 2006); Matthew Goldstein, "Card Shark Son's Bust," TheStreet.com (March 17, 2006) (available at http://www.thestreet.com/pf/markets/hedgefunds/10274146.html). The authors' firm represented one of the defendants in connection with the Princeton/Newport matter.

15. See SEC Staff Report at pp. 74-75; "Spitzer Alleges Mutual Funds Allowed Fraudulent Trading," Wall Street Journal (Sept. 4, 2003); see e.g., NASD Notice to Members 03-07 (June 16, 2003) (announcing disciplinary action taken against Altegris Investments, Inc. and its Chief Compliance Officer); see also *In the Matter of the Application of Brian Prendergast*, Exchange Act Release No. 44632 (Aug. 1, 2001) (SEC sustaining NASD bar and censure of hedge fund adviser for using materially misleading marketing literature).

16. Nina Mehta, "The Woes of Martin Armstrong," Derivatives Strategy (October 2000) (available at http://www.charttricks.com/Resources/Articles/armstrong_woes.pdf); see also *S.E.C. v. Princeton Economics Intern., Ltd.*, 338 F. Supp.2d 465 (S.D.N.Y. 2004).

17. Matthew Goldstein, "Lauer Capo Rolls," TheStreet.com (Aug. 22, 2003) (available at http://www.thestreet.com/_tscfoc/markets/matthewgoldstein/10109821.html). Robert J. Anello represented the consultant during those proceedings.

18. Will Swarts, "Friedlander Hedge Fund Manager Played Fast and Loose," TheStreet.com (Oct. 29, 2003) (available at http://www.thestreet.com/pf/markets/marketfeatures/10122906.html).

19. 15 USC §80b-3(b)(3).

20. 17 CFR §275.203(b)(3)-2(a); see also Investment Advisers Act Release No. 2333 (Dec. 2, 2004); Floyd Norris, "Court Says SEC Lacks Authority on Hedge Funds," The New York Times (June 24, 2006).

21. *Goldstein v. SEC*, — F3d —, 2006 WL 1715766, *3 (C.A.D.C. June 23, 2006).

22. Id.

23. Id. at **8-9.

24. Testimony of Gary J. Aguirre before the U.S. Senate Committee on the Judiciary, June 28, 2006 (available at http://judiciary.senate.gov/testimony.cfm?id=1972&wit_id=5485).

25. Testimony of Attorney General Richard Blumenthal before the Senate Committee on the Judiciary, June 28, 2006 (available at http://judiciary.senate.gov/testimony.cfm?id=1972&wit_id=4954); "SEC Lawyer Claims Firing Over Fraud Inquiry," The New York Times (June 28, 2006).

26. Testimony of Managed Funds Association before the Senate Committee on the Judiciary, June 28, 2006 (available at http://judiciary.senate.gov/testimony.cfm?id=1972&wit_id=5487).

27. See Hedge Fund Operations: Heaving Before the House Committee on Banking & Financial Services, 105th Cong. 37 (1998) (statement of Alan Greenspan, Chairman, Board of Governors, Federal Reserve System).

28. Ken Magill, "SEC Under Fire for Failure to Protect Small Investor," The New York Sun (April 21, 2004).

29. Joseph Hellrung, "Hedge Fund Regulation: Investors Are Knocking at the Door, But Can the SEC Clean House Before Everyone Rushes In?" 9 N.C. Banking Inst. 317, **341-342 (citing the dissenting opinion of SEC Commissioners Cynthia A. Glassman and Paul S. Atkins to the adoption of 17 CFR §275.203(b)(3)-2(a)).

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