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SEC'S FISCAL 2008 FOCUS ON HEDGE FUNDS

In fiscal 2008, the Securities and Exchange Commission continued its ongoing efforts to check improper activities of hedge funds. The actions taken include insider trading and manipulation cases against hedge fund management, as well as extraordinary rule-making designed to curb short selling, a core hedge fund strategy.

By Ronald E. Wood, Jeffery Gross, and Travis Brennan *

Few things snap regulators to attention like a scandal. And, few scandals match the brazenness, breadth or depth of the Ponzi scheme perpetrated by Bernard Madoff. The Madoff scandal caps off a year of unprecedented difficulty for hedge funds and further ensures that they will be a focus of regulators and Congress in 2009.

Since at least 2003, under the Chairmanship of William Donaldson, the SEC has made clear its desire to do more to regulate or manage, where possible, the activities of hedge funds, which remain a blind spot beyond the Commission's regulatory view.[1] The Commission's prior attempt to require hedge fund advisers to register under the Investment Advisers Act of 1940, thereby vesting it with regulatory jurisdiction over them, was struck down by the U.S. Court of Appeals for the District of Columbia Circuit in the 2006 case, *Goldstein v. SEC*.[2] Some of the areas highlighted for review prior to *Goldstein* have, in subsequent years, become the subject of special focus. For example, trade activity, particularly short selling and the potential for it to be used for manipulative or other improper purposes, remains a high priority.[3] Indeed, the SEC took several extraordinary steps during FY 2008 aimed at protecting the market from predatory short selling, particularly by hedge funds. This followed the sudden and dramatic collapse of Bear Stearns and the resulting ripple effect leading to the decimation of the U.S.'s once-dominant investment banking community, including the later failure of Lehman Brothers, the near failures of Merrill Lynch and Wachovia, and the conversion of Goldman Sachs and Morgan Stanley from investment banks to bank holding companies. These developments sparked

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[1] *See*, *generally*, Testimony of William H. Donaldson, Before the Senate Committee on Banking, Housing and Urban Affairs, April 10, 2003.

[2] 451 F.3d 873 (D.C. Cir. 2006).

[3] Chairman Donaldson noted that short selling by hedge funds represented a "special concern" due to their lack of transparency. Donaldson testimony at p. 9.

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concern that a targeted short selling campaign by a group of deeply capitalized investors, such as hedge funds, could accelerate the demise of vulnerable issuers in an already financially and psychologically weakened market.[4]

In addition to FY 2008's wobbly market, the SEC's year-end report noted a 25% increase in insider trading cases.[5] A few noteworthy such cases involved hedge funds, which current Chairman Christopher Cox in 2007 proclaimed would be a priority focus over the next two years.[6] Combined with the recent regulatory actions targeting short selling and the formation of a special hedge fund working group within the Division of Enforcement, the SEC seems committed to continuing its battle with the hedge fund industry for the foreseeable future.[7]

FRAUD AND MISAPPROPRIATION

Each year the SEC brings a raft of fraudulent offering and misappropriation cases, and 2008 was no exception. In *SEC v. Thompson Consulting, et al.*,[8] the Commission charged a Salt Lake City hedge fund manager, Thompson Consulting ("TC"), along with its president, in-house counsel, and investment adviser with misrepresenting the strategy and methods used to manage two hedge funds, the Apex Equity Options Fund and the Premier Portfolio Fund. Where TC, its control person, and agents told current and prospective investors the funds would employ option trading strategies designed to minimize risk, such as "straddles" and "strangles," the Commission alleged that, in fact, TC and the others failed to hedge certain option positions, causing the funds to be exposed to inordinate risk, which was later realized when the underlying securities declined in value. One security on which put options were allegedly written in 2007 was New Century Financial Corp., a subprime lender, which was one of the first to fail.

According to the complaint, TC caused the funds to write large volumes of put options on New Century's stock, for which the funds received income from premiums. In return, the funds gave option holders the right to have the funds buy their New Century shares at the contract price if New Century's price declined, as it did. Because the funds had not hedged these options with offsetting call contracts, they had to purchase tens of thousands of New Century shares at prices well above the then prevailing market price, and lost millions of dollars when they later sold the stock into a declining market. TC caused the funds to suffer a similar fate on another unhedged position in contracts on the Chicago Board Options Exchange Volatility Index. The net result of these transactions is alleged to have nearly wiped out the two funds. The Commission alleged that, to hide these losses from certain clients, TC's in-house counsel misappropriated approximately $3 million from the funds by transferring it to an account through which the client was funding a real estate transaction, later declaring the transfer to be a loan that was not documented. The president, in-house counsel, and adviser also allegedly caused more than $1.4 million to be transferred from the funds' accounts. The case is pending.

INSIDER TRADING

The informal culture of hedge funds has long raised concern about information sharing and the frequency with which employees of hedge funds, and hedge fund managers gain access to, and trade on, material non-

[4] *See* Rel. No. 58591, September 18, 2008.

[5] Rel. No. 2008-254, October 22, 2008, *SEC Announces Fiscal 2008 Enforcement Results.* The federal fiscal year runs October 1 through September 30.

[6] Carrie Johnson, *13 Charged in Big Insider Trading Scam*, Washington Post, Friday March 2, 2007, p. A1: "SEC Chairman Christopher Cox affirmed that policing possible insider trading by hedge funds would be a top regulatory priority over the next two years."

[7] As one prominent hedge fund manager has observed, hedge funds "are blamed for every spasm in the financial markets, and there is a perception that they often act together in vicious conspiracies to destabilize the world." Barton Biggs, *Hedge Hogging*, p. ix (2006).

[8] 2:08-cv-00171 (D. Utah).

public information.[9] Lacking any regulatory requirement to maintain separate functions, hedge fund employees are free to mix and share information received from external sources, including former colleagues from prior employment at other hedge funds, investment banks, and brokerage houses, which many have, and strategic investors or others having relationships with companies in which the fund invests. Concern over such free flow of information contributed, in part, to the SEC's 2007 formation of a special hedge fund working group. In introducing the working group to the Senate Banking, Housing, and Urban Affairs Committee, Chairman Cox noted that it was designed in part "to coordinate and enhance our efforts to combat hedge fund insider trading. . . ." Considering that the SEC has long been aggressive in pursuing insider trading, irrespective of the trader's identity or position, establishing a special group targeting hedge funds reflects obvious continuation of former Chairman Donaldson's "special concern" with that industry.

In this regard, the SEC in FY 2008 achieved finality in two previously filed high profile insider cases involving hedge funds, both of which resulted in criminal charges stemming from trading rings involving multiple traders linked through a common hedge fund employee. And, in a newly filed case, the SEC heavily penalized a hedge fund analyst for improperly short selling stock in advance of an anticipated "PIPE" (private investment in public equity) transaction, an area in which the Enforcement Division has been active the past few years, yet continues to find improper trading.

In the first of the two criminally charged cases, *SEC v. Michael K.C. Tom, et al.*,[10] originally filed in September 2005, the lead defendant, Michael Tom, manager of a small Massachusetts hedge fund, received a tip about an impending acquisition from a longtime friend and bank analyst, Shengnan Wang, who along with her husband was also an investor in Tom's fund. Upon receiving the tip, Tom caused his fund to invest in the target company. He also tipped his brother and bought call options and common stock in a series of personal and family accounts, including a joint account held with his wife, and accounts managed for his wife and in-laws. Through his fund and these various accounts, Tom and others, including the fund and its adviser, realized profits of nearly $750,000.[11]

After the civil case was filed, the Boston U.S. Attorney's Office charged Tom in a criminal information. In February 2006, he pled guilty to five counts of insider trading, and in November 2006, was sentenced to 36 months probation.[12] Tom, the fund, and its adviser finally resolved the SEC action in May 2008, agreeing to pay a total of $1,053,327.60 in disgorgement, interest, and penalties.[13] While the nearly $750,000 in ill-gotten gains is certainly significant, the facts of the case do not otherwise appear to raise a criminal profile. None of the traders were high profile individuals, for whom criminal prosecution might enhance a deterrent effect, and the misappropriation itself was a one-time event. The lack of obvious indications for why the case was criminally charged raises the question of whether Tom's status as a hedge fund manager, and the fact that he traded through a hedge fund account – breaching his duty to investors and tainting the fund with illicit gains, on which he and the adviser received performance fees – played a role in the charging decision, in line with the recent focus on hedge fund activity.[14]

The second previously filed case involving a hedge fund manager that concluded in 2008, and that also involved criminal charges, targeted "one of the most pervasive insider trading rings since the days of Ivan Boesky and Dennis Levine."[15] The case was filed in March 2007 and involved two trading rings, the first of which centered around hedge fund manager Erik Franklin and his longtime friend, Mitchel Guttenberg.[16] As part of the scheme, Guttenberg, an executive director in UBS's equity research department, would tip Franklin with information about pending changes in UBS research recommendations that were anticipated to move the market. Franklin used the information to trade through accounts he managed on behalf of an internal Bear Stearns hedge fund, Lyford Cay Capital, and Q Capital Investment Partners, a New Jersey hedge fund Franklin himself formed. He also tipped a portfolio manager at another hedge fund where he worked in between his time at Bear Stearns and Q Capital. The Guttenberg-Franklin scheme lasted five years, and netted millions of dollars in gains for Franklin and others.

[9] Gregory Zuckerman, *Are Hedge Funds Root of All Evil or Convenient Scapegoats*, WSJ.com, p. 2 (July 18, 2008).

[10] Lit. Rel. No. 20565, May 12, 2008.

[11] *Id.*

[12] Case 1:05-cr-10361-RCL, filed December 28, 2005.

[13] Lit. Rel. No. 20565, May 12, 2008.

[14] Tom's tipper, Shengnan Wang, was also criminally charged but received a lighter sentence.

[15] Jenny Anderson, *13 Charged in Insider Trading Ring*, NY Times, March 2, 2007.

[16] *SEC v. Mitchel S. Guttenberg, et al.*, Lit. Rel. No. 20022, March 1, 2007.

Guttenberg and Franklin pled guilty to insider trading and conspiracy charges in 2007, and Guttenberg was sentenced to 78 months. The SEC case against them is still pending.

The second trading ring involved a Morgan Stanley lawyer and compliance officer, Randi Collotta, who, along with her husband, also a lawyer and a Florida broker, traded stocks of companies whose merger and acquisition intentions Collotta learned from her work in Morgan's compliance department. The broker, in turn, tipped a friend who happened to know Franklin, providing Franklin yet another stream of illegal inside information. Collota and her husband pled guilty to securities fraud and conspiracy, and settled the SEC case with Collotta being enjoined and barred from future association with any broker-dealer or investment advisor and from practicing before the Commission.

From their status as industry professionals and members of the bar, who presumably appreciated the impropriety of their actions, Franklin's and the other traders' conduct presented a far more obvious risk of criminal prosecution than that of the Tom defendants. The fact that the schemes involved multiple stocks and occurred on multiple occasions – or, in the case of the Guttenberg-Franklin scheme, over many years – further elevated the conduct to a criminal level. Also contributing to culpability was Franklin's position as a fiduciary, with the attendant obligation to safeguard and advance the interests of his fund's investors rather than repeatedly expose them to liability and disrepute, all for his personal gain.

In the most recently filed FY 2008 insider trading case involving a hedge fund, the SEC alleged that hedge fund analyst Brian Ladin advised his fund, Bonanza Master Fund, Ltd. in February 2004 to sell short 100,000 shares of Radyn Comstream, Inc., after receiving confidential information that Radyn was seeking to close a PIPE transaction on behalf of two majority shareholders.[17] PIPEs are generally viewed as negative events inasmuch as PIPE shares are typically restricted, and therefore cannot be immediately sold, requiring that they be offered at a discount to attract and compensate buyers for the period and risk of illiquidity. The discounting and eventual release of new shares in turn have a dilutive effect on existing shareholders.

The SEC alleged that Ladin learned of the pending transaction from the placement agent handling the PIPE. After agreeing to keep information about the transaction confidential, and apparently believing the transaction would negatively impact the stock price, Ladin recommended that Bonanza sell short Radyn common stock. On Ladin's recommendation, Bonanza took a 100,000 share short position, from which it benefited when the stock price later declined following public announcement of the transaction.

Ladin settled the case for disgorgement of only $10,895, representing his portion of ill-gotten gains, plus $2,532 in prejudgment interest. Yet, he was assessed a civil penalty of $317,000 – 29 times his disgorgement amount – representing the amount of gain he caused Bonanza to realize on the transaction.

If the size of Ladin's penalty, Tom's criminal charge in what seems an otherwise garden variety case, and the motivation behind the hedge fund working group are indicative of how the SEC intends to "combat" insider trading by hedge funds, fund managers and traders would be wise to learn the lesson that being in an industry of special concern to the SEC will not require millions of dollars, high profile personalities, or multiple offenses to invite aggressive sanction, and even criminal prosecution.

The Commission's aggressiveness in the insider trading and PIPEs areas was also tempered by two significant setbacks in 2008, in cases where one court dismissed a section 5 claim against a hedge fund that sold short in a series of PIPE transactions, and another rejected the Commission's materiality theory predicate in a non-fund insider trading case.

In *SEC v. Lyon*,[18] the Commission charged hedge fund manager Edwin Lyon and his "Gryphon" family of funds and fund advisors with insider trading and violation of section 5 of the Securities Act of 1933, for short sales made in connection with at least three dozen PIPE offerings. Because of the tendency of PIPE transactions to cause the issuing company's stock price to decline, Lyon typically hedged his funds' PIPE purchases through short sales, which he later covered once the PIPE shares were registered and approved for trading. From the number of PIPEs Lyon and the Gryphon funds purchased and hedged, he obviously found this a beneficial strategy. As the shares ultimately used to cover the short positions were not registered at the time of the short sale, however, the Commission contended that Lyon's short sales amounted to unregistered offerings and sales in violation of section 5.

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[17] *SEC v. Brian Ladin,* Lit. Rel. No. 20784, October 20, 2008.

[18] 529 F. Supp.2d 444 (S.D.N.Y. 2008).

The court rejected this position, noting that a short sale involves a two-step process, the first being sale of shares the seller does not own, followed, eventually, by replacement of those shares. As Lyon and Gryphon regularly borrowed and sold short publicly available shares, they did not violate the registration requirements of section 5. The court reasoned that use of PIPE shares to close the position[19] – shares which, while not registered at the time of the short sale, but *were* registered at the time of delivery – was not relevant to the section 5 analysis as it is the shares sold in step one, when section 5 applies, that must be registered. The subsequent use of later registered shares to close the position simply did not reach back to change the character of the borrowed shares sold in step one. "How an investor subsequently chooses to satisfy the corresponding deficit in his trading account does not alter the nature of that sale."[20]

The setback in *Lyon* was significant motivation to cause the SEC to voluntarily amend a complaint leveling similar allegations in a pending Pennsylvania case.[21]

In *SEC v. Mangan*,[22] the Commission alleged that stockbroker Mangan learned about a PIPE transaction from his employing broker-dealer, which had been hired to advise on and promote the deal. The evening before the transaction was to be announced, Mangan and his business partner agreed to purchase shares in the PIPE through an entity the partner owned, with Mangan lending funds for the purchase. They agreed to split any profits or losses.

The deal was priced after the market closed on October 8, 2001. Before the next day's open and public announcement of the deal, Mangan directed his firm's trader to sell short the issuer's stock for the entity's account, which he and his partner planned eventually to cover with PIPE shares.

The short sale price was significantly below the prior day's closing price, $14.16 vs. $17.38, and even below the price at which the stock was trading when the PIPE was later announced, $14.50. The price actually increased followed the announcement, but fell again, and ultimately closed at $14.25, below the pre-announcement price of $14.50, but still above Mangan's $14.16 transaction price.

The Commission alleged that Mangan sought to profit from the material information he received about the PIPE. The Commission's theory of materiality focused on the negative price movement between the closing prices on the day before the announcement and the day of the announcement, $17.38 vs. $14.25, an 18% drop. The court rejected this theory, citing the Second Circuit's 1972 approval of a jury instruction measuring materiality at the time the buyer and seller are committed to the transaction, *i.e.*, the time of execution.[23] The court further observed that in an efficient market, materiality is determined by whether and how much a particular event alters the stock price.

From this perspective, the price at the time of execution, $14.16, was lower than both the price immediately prior to announcement ($14.50) and the day's closing price ($14.25). Focusing on the difference between the execution price and the closing price on the day of the announcement, a change of just .09%, the court concluded that such difference did not support a finding of materiality; indeed, quite the contrary: "The unbiased market of reasonable investors clearly determined that the information was immaterial."[24] Because the Commission could not establish a genuine issue as to materiality, the court granted summary judgment for Mangan, a ruling that may even have altered the landscape for determining materiality in future insider trading claims.

SHORT SELLING

In response to the financial crisis that precipitated the demise, first, of Bear Stearns, then Lehman Brothers, and seeking to prevent a domino effect, the SEC took several initiatives in FY 2008, including emergency action targeting short sellers as part of its efforts to stave off potential bear raids in a weak market environment.[25]

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[19] Some of Lyon's trades were conducted in Canada, which, at the time, permitted "naked" short selling, *i.e.*, selling shares one did not own without having a ready source from which to borrow the shares.

[20] 529 F. Supp.2d, at 455.

[21] *SEC v. Berlacher*, 07 Civ. 3800 (E.D. Pa. Sept. 13, 2007). The SEC withdrew its section 5 claim, leaving its claims for fraud and insider trading. The SEC claims that Berlacher and his friends falsely represented to PIPE issuers that they had no intent to distribute PIPE shares, when in fact they planned all along to use PIPE shares to cover their short positions, causing the shares to be distributed.

[22] 2008 U.S. Dist. LEXIS 64814 (W.D.N.C. Aug. 20, 2008).

[23] *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876 (2d Cir. 1972).

[24] 2008 U.S. Dist. LEXIS 64814, p. 4.

[25] A July 18, 2008 Wall Street Journal article commented that hedge funds are "more likely to gang up on a stock than, say,

The first initiative prohibited the practice of "naked" short selling, which occurs when a seller does not borrow securities needed to cover a short position in time to make delivery within the three-day settlement period. This was later followed by rare emergency actions protecting more than 900 specific issues from short sale, and requiring hedge fund and other money managers to disclose their short positions. In adopting these emergency measures the Commission noted that sudden declines in stock price can raise questions about an issuer's financial condition and impair its liquidity and viability, with potentially broad market consequences.[26] Bear Stearns presents a case in point.

Bear's failure was largely precipitated by investors' loss of confidence in the firm's ability to continue repaying its loans, including its short-term overnight loans, or satisfy its obligations under agreements with other financial institutions.[27] As a consequence, counterparties were unwilling to make secured funding available on customary terms.[28] The fall of Bear Stearns, arguably brought about or at least exacerbated by short selling, heightened market concern about the overall health of US financial institutions. It also heightened the SEC's concern with short selling.

Even prior to Bear's failure, the SEC had moved, in early March, to ban naked short selling by proposing new antifraud Rule 10b-21. On July 15, 2008, after Bear had failed, and motivated to prevent other financial institutions from failing, the Commission issued an emergency order prohibiting naked short selling in the securities of 19 "substantial financial firms" for an eight-day period.[29] The order was issued in light of what the SEC characterized as a "substantial threat of sudden and excessive fluctuations of securities prices" that could threaten fair and orderly markets.[30]

Then, on September 14, 2008, Lehman Brothers failed, leaving behind a 150-year history and commencing the largest bankruptcy in US history. Three days later, the SEC issued another emergency order imposing enhanced delivery requirements and related penalties on short sales on all equity securities, and making Rule 10b-21 immediately effective.[31] The order was intended to discourage short sellers from exerting artificial downward pressure through naked short selling in a weakened market. The next day, September 18, 2008, the SEC and Britain's Financial Services Authority ("FSA") banned short selling in the securities of nearly 800 financial institutions for a two-week period, with limited exceptions. Three days later, on September 21, 2008, the SEC amended the order, allowing the national exchanges to supplement the list of protected issuers, which then grew to more than 900 financial institutions.

Not surprisingly, the hedge fund industry was immediately critical of the short selling ban and skeptical that it would achieve its intended result. On September 19, 2008, two industry groups, the Alternative Investment Management Association and the Managed Funds Association ("MFA"), criticized the short selling ban. The MFA, which represents more than 600 hedge and managed futures funds, observed that following expiration of the July emergency order, the price of the majority of the 19 stocks covered by that order had declined in value during the period the order was in effect.[32] An MFA spokesman noted that it "remains unclear that the restrictions provided any benefit whatsoever."[33] There is some truth to MFA's position. After the September ban expired, it was reported that review of academic literature and a flash study by Nasdaq OMX revealed that stocks covered by

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footnote continued from previous page…

mutual fund managers." *See* Gregory Zuckerman, *supra* note 9.

[26] *See* Rel. No. 58591, September 18, 2008.

[27] In February 2008, Bear Stearns was trading around $90 per share. In early March, rumors began about the firm's financial health. On March 10, the company issued a press release denying it was having financial troubles. On Friday, March 14, the stock closed at $30.00 per share, down 47% on the day. Two days later, on Sunday, March 16, 2008, JP Morgan Chase announced that it was acquiring Bear Stearns for $2.00 per share, reflecting that the values of the company's assets were much lower than the market previously believed. On March 17, 2008, the New York Times reported that Bear Stearns had been forced to arrange a quick sale to protect the business from collapsing entirely, as most financial houses had stopping trading with the firm. Andrew Ross Sorkin, *JP Morgan Pays $2 a Share for Bear Stearns*, New York Times, March 17, 2008.

[28] Rel. No. 58166, July 15, 2008.

[29] *Id.*

[30] *Id.*

[31] Rel. No. 58572, September 17, 2008.

[32] Richard Baker, *Managed Funds Association Opposes Short Selling Ban and Short Position Reporting Requirements*, MFA news release, September 19, 2008.

[33] *Id.*

the nearly month-long ban had actually became more volatile.[34]

In an equally, if not more, controversial move – its third to check short selling in FY 2008 – the SEC, on September 18, 2008, required hedge fund and other institutional money managers to file weekly reports detailing daily short sale activity.[35] The new disclosure requirement was designed to provide the Commission with real-time insight into hedge funds' short selling activity during the financial crisis. It applied to all fund managers with more than $100 million invested in securities, and noted that the filings would be publicly available via the EDGAR system. Though the requirement applied to all institutional money managers, the Commission was well aware that it would likely affect hedge fund managers more than others.[36] Indeed, even its website notes that it "approved emergency rule-making to ensure disclosure of short selling positions of hedge funds."[37] And, as a Reuters story noted, unlike hedge funds, mutual funds usually do not sell stocks short.[38] The rule, thus, was clearly targeted at hedge funds.

As with the July order, this requirement also drew immediate fire from the hedge fund industry; it ultimately persuaded the SEC to amend the order, which the Commission did on October 2, 2008. In a concession to the industry, the amendment provided that the new disclosure form, Form SH, disclosing short positions, would not be publicly disclosed. On the other hand, it extended the filing period from October 2, when it was originally set to expire, through October 17, 2008.[39] The requirement was extended again on October 18, 2008, and is now effective until August 1, 2009.[40]

Through these various actions, taken during a period of great market upheaval, the SEC has achieved a degree of insight into at least one core area of hedge fund activity, something it has sought since its defeat in the *Goldstein* case. It may not be long before additional disclosure requirements are enacted to achieve an even more comprehensive look. Should the current climate continue, there may be other occasions for the Commission to pursue emergency actions that further widen its view into hedge fund activity.

In addition to these regulatory steps, the SEC was also active against short sellers on the enforcement front. On April 24, 2008, it charged Paul Berliner, a proprietary trader with the Schottenfeld Group, with fraud stemming from a short selling scheme in which he allegedly fabricated and spread negative rumors about Blackstone Group's plan to acquire Alliance Data Systems ("ADS"), at a time when Berliner was selling short ADS stock.[41] The complaint alleges Berliner drafted and disseminated by instant message the false rumor that ADS's board of directors was meeting to consider a revised Blackstone proposal to acquire the company at a significantly lower price than originally proposed. Berliner allegedly disseminated the rumor to traders at hedge funds and brokerage firms, apparently to induce them to sell or short sell ADS stock. When the rumor hit the financial press, ADS's share price fell dramatically on heavy trading. Berliner allegedly profited by covering his short position as the price fell. He was ordered to pay $26,129 in disgorgement and prejudgment interest, and a $130,000 civil penalty.

Following this case, and perhaps because of it, the SEC on September 19, 2008, announced a "sweeping expansion" of its ongoing investigation into possible market manipulation in the securities of certain financial institutions. With the issuance of a formal order of investigation, enforcement staff may now subpoena documents and testimony relevant to its investigation into manipulative and "abusive" short selling practices and illegal "rumor mongering." According to the disclosing release, hedge fund managers, broker-dealers, and institutional investors with significant trading activity in certain financial issuers, or positions in credit default swaps, will be required to disclose these positions, under oath, and provide certain other information.

MANIPULATION

Less visible than the FY 2008 crackdown on short selling, but just as significant for hedge funds and their

[34] David Greising, *Short-Selling Ban Leaves SEC with Little to Show*, Chicago Tribune, October 10, 2008.

[35] Rel. No. 58591, September 18, 2008.

[36] Staff Report, *Implications of the Growth of Hedge Funds*, September 2003, p. 42, acknowledging that, for hedge funds, short selling is "a major component of their investment strategy."

[37] *Available at* www.sec.gov/news/press/sec-actions.htm.

[38] Svea Herbst-Bayliss and Rachelle Younglai, *Hedge Funds Gird for SEC Disclosure Fight*, Reuters, October 3, 2008.

[39] Rel. No. 58724, October 2, 2008.

[40] Rel. No. 58785, October 15, 2008.

[41] Lit. Rel. No. 20537, April 24, 2008.

advisers, are signs of increasing efforts to combat other forms of market manipulation. Because hedge fund managers are often compensated, in part, with a percentage of the fund's net asset value ("NAV") at the end of each reporting period, there is a strong incentive for managers to achieve and report ever-increasing returns to investors. In addition, many hedge funds employ strategies involving thinly traded over-the-counter securities, "penny stocks," which are relatively illiquid, difficult to objectively value, and prone to price manipulation, particularly when most or all of the stock is held by a small number of investors. Some fund managers have even used their positions in penny stocks to artificially inflate NAV, thereby increasing their fees, a practice known as "portfolio pumping." A recently filed administrative proceeding demonstrates that the SEC is becoming more aggressive in combating this lesser-known form of hedge fund manipulation.

On October 16, 2008, the SEC filed a settled administrative proceeding against San Francisco hedge fund manager MedCap Management & Research, LLC ("MMR") and its principal, Charles Frederick Toney, Jr., who allegedly engaged in portfolio pumping and, as a result, reported misleading results to their investors. MMR and Toney advised MedCap Partners, L.P. ("MedCap"), a hedge fund that suffered significant losses through most of 2006. The SEC alleged that, over the last four days of September 2006, Toney, through a separate fund that MMR managed, placed numerous buy orders for a thinly traded penny stock in which MedCap was heavily invested. Toney allegedly placed orders for the stock at ever-increasing values at or above the "Inside Ask" (or lowest ask) price, thereby ensuring that his orders would be executed. This false demand caused the stock price to increase from $0.85 to $3.72.

Because the stock represented over one-third of MedCap's value, the brief increase in its price inflated MedCap's value by $29 million, effectively doubling the value and hiding what would otherwise have been a 40 percent quarterly loss for MedCap. Toney allegedly failed to disclose to MedCap's investors that this price bounce was almost entirely due to Toney's four-day "purchasing spree." After the quarter ended, and following MMR's brief buying activity, both the stock price and MedCap's NAV declined to previous levels. MMR charged fees to the fund based on the inflated quarter-end asset value.

Though MMR is not registered with the Commission, because it advises fewer than 15 hedge fund clients, the SEC was nevertheless able to charge it with violations of the antifraud provisions of Adviser Act Section 206 (1) and 206 (2).[42] MMR agreed to disgorge $61,180.08 plus prejudgment interest. Toney was barred from association with any investment adviser for one year and ordered to pay a civil penalty of $100,000.

As the MedCap case demonstrates, although short selling is currently the public face of the SEC's crackdown on market manipulation, it is not the only type of manipulative activity being reviewed. Increasingly unfavorable market conditions will only increase the temptation on hedge fund managers to find ways to enhance returns, possibly presenting temptations that should be avoided at all costs. The SEC has shown that it is paying close attention.

CONCLUSION

The collapse of the subprime industry and subsequent roiling of the capital markets made for extraordinary events in FY 2008, and the SEC responded with extraordinary regulatory measures, including various limitations on short selling, which disproportionately impacted hedge funds. Hedge funds and those who manage them may also find themselves the subject of harsh enforcement sanctions where insider trading or market manipulation are alleged. In both respects, the SEC has been very open about its focus on hedge fund activity, which may mean that what it was not able to achieve through the registration requirement rejected in *Goldstein,* it will pursue through emergency rule-making or enforcement action.

However the current market shakes out, at least one group should take care to adopt best practices and stay well clear of the firing line, as a step too far could court disaster.■

[42] MMR is registered with the California Department of Corporations.