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SEC Already Has Necessary Tools to Punish Hedge Fund Fraud

By Marc D. Powers and James Pfeffer

During the past few weeks, the world has focused its attention on the financial mayhem in global markets and the ensuing debate in Washington and other capitals about how to contain and solve it. Suddenly, the arcane realm of complicated financial products has spawned inquiry, arguments, and outright outrage. Indeed, it seems that the only thing about which anyone can agree is that credit was too easy, mortgage applications too dishonest, and too many bankers bet too much of someone else's money. In response, a theme has emerged that we must vest our regulators with new powers, and more of them, to extend their bailiwick across the entire financial landscape. In particular, because they're lightly regulated, hedge funds will be an easy target. This is dangerous for two reasons.

First, as some commentators have written, the more important question concerning the financial crisis is not who sold the toxic mortgages, but rather who bought them, and by extension, who did not.[1] The principal buyers have been the investment banks, the more-tightly-regulated commercial banks, and the super-tightly-regulated Fannie Mae and Freddie Mac. Only the lightly-regulated hedge funds dabbled, but refused to join the "clean plate club" that has devoured the fetid mortgages. And while investment banks, commercial banks, and Fannie and Freddie have battled food poisoning all year, hedge funds that did not utilize any or excessive margin loans have been relatively healthier (though they have experienced large withdrawals).

Second, the Securities and Exchange Commission's existing powers to combat fraud work. For example, lost amid news of the sky falling, was a recent decision in the Southern District of Florida, *SEC v. Lauer et al.*[2] In *Lauer*, Judge Kenneth A. Marra applied the federal securities laws and granted the SEC's motion for summary judgment against a hedge fund manager and his operating company. In doing so, Judge Marra demonstrated that when the issue is preventing securities fraud in hedge funds, the SEC already has overwhelming and decisive weapons in its arsenal.

Judge Marra also, impliedly, revealed the wisdom in the D.C. Circuit's 2006 decision in *Goldstein v.SEC.*[3] There, the court vacated the SEC's ruling that the Investment Advisers Act of 1940 ("Advisers Act") required advisers to register with the Commission.[4] Thus Judge Marra's decision shows that the SEC actually has sufficient power to protect hedge fund investors. Hence we should listen with caution when the clean up to the current financial crisis calls for tighter oversight of hedge funds.

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We should also ask if more aggressively regulating hedge funds would have solved some of this year's major problems. Specifically, would it have really mattered in averting this financial crisis if the SEC had full inspection rights over these investment pools for the rich? Apparently, the SEC had full access to the books and records of various investment banking firms Bear Stearns and Lehman Brothers. But that did not prevent them from failing.

History of Regulation

Traditionally, hedge funds were exempt from the Advisers Act because they had fewer than 15 "clients." One "client" was defined, in effect, as the investment vehicle (limited partnership or LLC), not the number of individual partners or members. This held, as long as the hedge fund manager did not give individualized advice to a partner or member.

Recently, that exemption changed for several reasons. First, the debacle of Long Term Capital Management, in late 1998, showed how connected funds could be to the overall economy.[5] Also, as the flow of money into funds increased from the millions to the billions, regulators and Congress realized that the stakes of problems in funds had increased exponentially. So following several years of regulatory study, and a period of notice and comment, in 2004 the Commission issued the "Registration Under the Advisers Act of Certain Hedge Fund Advisers" (the "Hedge Fund Rule"). In effect, this provision required fund advisers to register with the SEC because the Rule defined "clients" as individual investors, rather than as the funds themselves.

Almost instantly, the Hedge Fund Rule became the subject of litigation in the D.C. Circuit by hedge fund adviser Philip Goldstein, who challenged the Rule's equation of "client" with "investor."[6] The D.C. Circuit ruled for Goldstein and vacated the SEC's regulation,[7] holding that the adviser's client is indeed the fund itself, rather than the fund's investors. This means that the fund's adviser owes fiduciary duties only to the hedge fund, and not the hedge fund's investors. Otherwise the adviser could face conflicts of interests.[8]

Nevertheless, the holding hardly stripped the SEC's power to discipline advisers who engage in fraud or breach of their fiduciary duties. Though hedge fund advisers do not currently need to register with the SEC, the Advisers Act's anti-fraud provisions still govern their behavior.[9] And as the *Lauer* case demonstrates, the Securities Act of 1933 ("Securities Act"), the Securities Exchange Act of 1934 ("Exchange Act") and the Advisers Act provide a figurative buffet of counts for the SEC to include when suing a hedge fund adviser.

SEC v. Lauer

In 1997, Michael Lauer set up several Greenwich, Connecticut,-based investment management companies. Lauer used these companies to create and run three hedge funds, Offshore, Partners and OmniFund (the "Funds"). The Funds pooled investments in securities on behalf of qualified investors. Lauer then managed the Funds in exchange for fees, which were calculated on the basis of the Funds' asset values.[10] In 2003, the SEC sued Lauer and his investment vehicles, in the Southern District of Florida, seeking to enjoin him for breaking the federal securities laws. The Commission argued, in effect, that Lauer sought to inflate his management fees by lying about the Funds' valuations and the quality of their underlying assets.

After protracted litigation, the court granted the SEC's motion for summary judgment, concluding that Lauer "violated the antifraud provisions of the federal securities laws by conducting an elaborate scheme to defraud investors."[11] In particular, the court held that Lauer violated Sections 17(a) of the Securities Act, Section 10(b) and Rule 10b-5 of the Exchange Act, both individually and as a control person under Section 20(a) of the Exchange Act, and the antifraud provisions of the Advisers Act-Sections 206(1) and 206(2).[12] Judge Marra found that Lauer artificially inflated the Funds' net asset values; manipulated the prices of the assets that the Funds held; misrepresented the nature, quality, size, and even existence of many of those assets; and hid his fraud by giving investors "sham" portfolios and "false and misleading" private placement memoranda, and bogus statements.[13] Thus the court decided that a permanent injunction was warranted because the conduct was "egregious, pervasive,

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premeditated and resulted in the loss of hundreds of millions of dollars in investors' funds."[14]

Another gap left open by the *Goldstein* decision was the issue of to whom does the manager owe a duty—to the fund itself, or the individual partners? In 2007, the SEC by regulation, cleared up that possible hole by issuing Rule 206(4)-8.[15] The rule, in effect since September, 2007, states that it is fraudulent conduct under the Advisers Act to misrepresent or defraud "any investor or prospective investor in the pooled investment vehicle." In practice, this was more "belts and suspenders" than meaningful. Indeed, the *Lauer* court, ruling on conduct that preceded the new Rule, had no problem finding Lauer had defrauded his investors and prospective investors, under the Advisers Act, without even citing the new provision.

Though the case's facts are extreme, *Lauer* is a useful reminder that existing regulations still work well and serve their purpose—even when the subject is hedge funds. The present turmoil in the U.S. and global marketplace will probably prompt a call for greater oversight and regulation of funds. This is understandable and, perhaps, needed. Because it is true, of course, that financial products, assets, tools, models and, indeed, hedge funds have all grown dizzyingly complex. But human nature has not. Fraud is still fraud, and it is still illegal, even if it is in a hedge fund. Thus, as *Lauer* shows, the SEC currently has the full panoply of powers to fight and punish fraudsters. ◆

Endnotes

1. See,e.g., Sebastian Mallaby, *Deregulation Nonsense*, Wash. Post, October 6, 2008, at A15.
2. *SEC v. Lauer et al.,* 2008 WL 4372896 (S.D. Fla. September 24, 2008).
3. *Goldstein v. SEC,* 451 F.3d 873 (D.C. Cir. 2006).
4. 15 U.S.C. § 80b-1 et seq. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed.Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. pts. 275, 279)("Hedge Fund Rule").
5. *Goldstein,* 451 F.3d at 876-877.
6. *Goldstein,* 451 F.3d at 874.
7. *Goldstein,* 451 F.3d at 874-876.
8. *Goldstein,* 451 F.3d at 881 ("It simply cannot be the case that investment advisers are the servants of two masters.")
9. *Goldstein,* 451 F.3d at 876.
10. *Lauer,* 2008 WL 4372896 at *4.
11. *Lauer,* 2008 WL 4372896 at *25.
12. *Lauer,* 2008 WL 4372896 at *1.
13. *Lauer,* 2008 WL 4372896 at *25.
14. *Lauer,* 2008 WL 4372896 at *25.
15. 17 C.F.R. § 275.206(4)-8 (72FR 44761, Aug. 9, 2007).