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## SEC Plans New Approach To Pruning Hedge Funds

D.C. Circuit Court Of Appeals invalidates Commission's previous regulatory attempt

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**O**n June 23, 2006, a panel of the United States Court of Appeals for the District of Columbia Circuit unanimously invalidated the SEC's recent attempt to regulate hedge funds by requiring them to register as investment advisers. See *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, 69 Fed. Reg. 72,054 (Dec. 10, 2004) ("Hedge Fund Rule"); *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006) (invalidating the Hedge Fund Rule).

*Goldstein* concluded that the Hedge Fund Rule, which sought to redefine the term "investment adviser" in order to bring many more hedge funds within the regulatory ambit of the Investment Advisers Act, represented an unreasonable interpretation of the Act. On August

7, SEC Chairman Christopher Cox announced that the agency would not pursue any further appeals of the *Goldstein* decision, stating that "further appeal would be futile and would simply delay and distract from our goal of advancing investor protection."

### SEC Pursues Alternative Route

Lest hedge funds think that the SEC was abandoning its efforts to increase scrutiny and regulation of hedge funds, Cox also noted in his statement concerning *Goldstein* that the Commission was actively pursuing new hedge fund rulemaking and interpretive activities.

As described by Cox, the SEC is developing "a new anti-fraud rule under the Investment Advisers Act that would have the effect of 'looking through' a hedge fund to its investors."

The Commission believes that this proposal, if enacted, would provide enhanced protections

for hedge fund investors. Chairman Cox also directed the SEC staff to consider whether to increase the minimum asset and income requirements for hedge fund investors.

### Prior Enforcement Actions

Even without passage and implementation of the newly-proposed rules, the SEC's powers over hedge funds and their managers are still significant. The Commission's authority to investigate and punish securities fraud perpetrated by hedge funds or their management—such as insider trading—continues undiminished notwith-

standing *Goldstein*.

Chairman Cox's testimony to Congress in July of this year noted that the Commission is committed to bringing enforcement actions against those hedge funds and hedge fund advisers that commit securities fraud. According to his testimony, the Commission has brought

more than 90 enforcement actions against hedge fund advisers since 2001. Cox also asserted that the Commission's power to police securities fraud perpetrated by hedge funds and hedge fund advisers remained strong despite the *Goldstein* ruling.

While Cox's testimony did not detail the areas in which the SEC has focused its hedge fund-related enforcement activities, Linda Thomsen, the SEC's Director of Enforcement, recently testified before Congress regarding enforcement actions focused on insider trading activities by hedge funds and their managers. Thomsen testified that of the 44 insider trading cases brought by the SEC in fiscal year 2006 to date, five have involved hedge funds or their advisers, and several of those focused on trading by hedge funds in connection with Private Investments in Public Equity, commonly known as PIPEs.

PIPEs provide a means by which issuers



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of publicly-traded securities can raise additional capital without selling the securities on the open market. PIPE investors purchase unregistered stock that is usually locked up for a period of time while the shares are registered and made eligible for sale on the open market.

Hedge funds are frequent investors in PIPE transactions, and are in a position to take advantage of their access to information on the pricing and timing of PIPE placements. By issuing new shares in a company, PIPEs dilute the value of existing shares, possibly exerting downward pressure on the price of the company's stock.

In May 2005, the SEC brought an enforcement action against Hilary L. Shane, a manager of hedge fund FNY Millennium Partners LP, for allegedly agreeing to buy unregistered shares as part of a PIPE transaction in CompuDyne Corp., a publicly-traded corporation, and then short-selling registered CompuDyne stock before news of the PIPE transaction became public.

Shane and one of the funds she managed allegedly made substantial trading profits as a result of misuse of nonpublic information about the CompuDyne PIPE. Late last month, Shane was indicted on criminal insider trading charges by a grand jury in the Southern District of New York.

In March 2005, the SEC settled an enforcement action raising similar allegations against three other hedge funds and their portfolio manager, Jeffrey Thorp. See *SEC v. Langley Partners, L.P., North Olmsted Partners, L.P., Quantico Partners,*

*L.P., and Jeffrey Thorp*, Litigation Release No. 19607 (March 14, 2006). The consequences for both Shane and Thorp were severe: as part of the settlement of the case, Shane consented to a more than \$1M payment to the SEC and a bar from the broker-dealer industry, while Thorp and his funds were collectively required to pay almost \$16M to settle the charges.

These and other related enforcement activities arise out of the same concerns that led to passage of the Hedge Fund Rule that was defeated in *Goldstein*.

The SEC believes that the dramatic growth in the hedge fund industry has led to increased competition for returns; in this situation, according to Scott W. Freistad, an associate director with the SEC's Enforcement Division, "people sometimes cut corners."

The concern with hedge funds' temptation to abuse their access to inside information appears to be global; recently, market regulators in France and the United Kingdom have focused on alleged insider trading schemes similar to the ones referenced above.

### Future Enforcement Activities

Most hedge fund advisers are already attuned to the legal prohibition of trading on material nonpublic information. But as hedge funds invest in a more diverse asset pool, gain more assets, and obtain more influence over—and access to—the entities in which they invest, the funds' opportunities to come into possession of inside information increase dramatically.

Hedge funds' rapid entry into the sec-

ondary loan market, for example, enables many funds to obtain access to confidential "syndicate-level" information about borrowers. These syndicate-level reports may include inside information on borrowers' future revenue projections, planned acquisitions, or other strategic initiatives.

Yet many hedge funds lack clearly-defined Chinese walls separating those who purchase and sell the loans—and thus have access to the information—from those who may be trading in bonds, stocks, and other assets of the company. Hedge fund industry expert, Marc Baum, is quoted as saying that the funds are "just hoping that something terrible doesn't happen before the industry figures it out on its own, so the regulators don't end up coming in."

Another potential subject of future SEC focus may be "activist" hedge funds. "Activist" funds try to increase returns of investees by influencing company management and strategic direction.

While engaging in these tasks, however, the funds also may obtain access to the secrets of investees as a result of their unique relationship with these companies. This development could create significant insider trading exposure for funds that then seek to trade in the securities of a company while serving effectively as a company "insider."

Even after the demise of the Hedge Fund Rule, hedge funds should invest in compliance systems and personnel as they grow in size and complexity in order to prevent and detect insider trading or other securities fraud. ■