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INDEPENDENT FUND ADMINISTRATORS AS A SOLUTION FOR HEDGE FUND FRAUD

*Kent Oz**

INTRODUCTION

There is approximately $1.33 trillion invested in hedge funds worldwide.[1] Most of this money is invested in legitimate hedge funds,[2]

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1. Ianthe Jeanne Dugan, *Hennesee Settles SEC's Bayou Charges*, WALL ST. J., Apr. 23, 2009, at C10.

2. TAMAR FRANKEL & CLIFFORD E. KIRSCH, INVESTMENT MANAGEMENT REGULATION 160 (2d ed. 2003) ("[T]he term hedge fund is undefined, including in the federal securities laws . . . hedge fund has developed into a catch-all classification for many unregistered privately managed pools of capital."); *see also* Press Release, Office of Sen. Grassley, Grassley and Levin Introduce Hedge Fund Transparency Bill (Jan. 29, 2009), *available at* http://levin.senate.gov/newsroom/release.cfm?id=307481.

> Hedge funds are simply private investment funds in which the investors have agreed to pool their money under the control of an investment manager. What distinguishes them from other investment funds is that hedge funds are typically open only to "qualified purchasers," an SEC term referring to institutional investors like pension funds and wealthy individuals with assets over a specified minimum amount. In addition, most hedge funds have one hundred or fewer beneficial owners. By limiting the number of their beneficial owners and accepting funds only from investors of means, hedge funds have been able to qualify for the statutory exclusions provided in Sections 80a-3(c)(1) and (7) of the Investment Company Act, and avoid the obligation to comply with that law's statutory and regulatory requirements. In short, hedge funds have been able to operate outside the reach of the SEC.

Id.; *see also* William Fung & David A. Hsieh, *A Primer on Hedge Funds,* 6 J. EMPIRICAL FIN. 309, 309 (1999) ("[Hedge funds] are typically organized as limited partnerships, in which the investors are limited partners and the managers are general partners. As general partners, the fund managers usually invest in a significant portion of their personal wealth into the partnership to ensure the alignment of economic interests among the partners.").

with honest managers. In the last decade, however, some significant frauds have been uncovered. Unscrupulous hedge fund managers such as Samuel Israel, Michael Lauer, Paul Greenwood, Kirk Wright, James Nicholson and others have defrauded investors of billions of dollars.[3] These frauds, coupled with the current financial crisis, have brought intense scrutiny to the hedge fund industry.[4] Legislators have responded by introducing three bills in Congress that would generally compel hedge funds to register with the U.S. Securities and Exchange Commission (the "SEC").[5] These bills would also impose new disclosure and recordkeeping requirements on hedge funds.[6] Similarly, in June 2009, President Obama released his Administration's proposal to reform the regulation of the financial industry, which includes a provision for fund advisers to register with the SEC under the Investment Adviser Act, and also subject hedge funds to extensive recordkeeping and disclosure requirements.[7] The politicians that introduced these proposals claim that registration and the attending disclosures of hedge funds will protect investors and deter fraud.[8]

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3. Steve Stecklow, *In Echoes of Madoff, Ponzi Cases Proliferate*, WALL ST. J., Jan. 28, 2009, at A1; Steve Stecklow, *Pair Lived Large on Fraud, U.S. Says*, WALL ST. J., Feb. 26, 2009, at A1; Christine Williamson, *A Better Way to Hedge Against Fraud*, PENSIONS & INVESTMENTS, Sept. 1, 2008, *available at* http://www.pionline.com/article/20080901/PRINTSUB/309019975 (It is estimated that $9 billion has been lost in the past decade due to hedge fund fraud.).

4. Interview with James Jalil, Partner, Thompson Hine, in New York, N.Y. (May 28, 2009).

5. Hedge Fund Adviser Registration Act, H.R. 711, 111th Cong. (2009); Hedge Fund Transparency Act, S. 344, 111th Cong. (2009); Private Fund Transparency Act, S. 1276, 111th Cong. (2009).

6. *Id.*

7. *See* U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM—A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 3-4 (2009) [hereinafter FINANCIAL REGULATORY REFORM].

8. *Id.* at 2 ("We must build a new foundation for financial regulation and supervision that is simpler and more effectively enforced, that protects consumers and investors . . . "); Press Release, Office of Rep. Castle, Capuano, Castle Bill Would Improve Oversight of Hedge Funds (Jan. 27, 2009), *available at* http://www.house.gov/capuano/news/2009/pr012709.shtml (Representative Capruano: "In addition to providing us with basic census information on hedge funds, this measure can be used to detect and deter fraudulent practice and risky behavior before it's too late."); Press Release, Office of Sen. Grassley, *supra* note 2 (Senator Levin: "The Hedge Fund Transparency Act will protect investors, and it will help protect our financial system."); Press Release, Office of Sen. Reed, Floor Statement Introducing the Private Fund

This Note will discuss some of the non-market risks that hedge fund investors are exposed to, explore some current hedge fund frauds, and discuss whether disclosure[9] is really the most effective way to deter fraud in the hedge fund industry. The Note will conclude by proposing that third party custody of hedge fund assets would be the most effective deterrent against hedge fund fraud.

I. NON-MARKET RISKS FOR HEDGE FUND INVESTORS

Investors generally expect investments in hedge funds to be riskier[10] than investment in mutual funds or similar registered investment companies, and thus, deliver superior performance.[11] That is

Transparency Act of 2009 (June 16, 2009), *available at* http://reed.senate.gov/newsroom/details.cfm?id=316702 (Senator Reed: "these statutory changes will help modernize our outdated financial regulatory system, protect investors and prevent fraud").

9. *See* DIV. OF INV. MGMT. & OFFICE OF COMPLIANCE, INSPECTIONS & EXAMINATIONS, SEC, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS iv (2003) [hereinafter IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS] ("Because hedge funds are not registered investment companies, they generally are not required to meet prescribed disclosure requirements."). If any of the bills or President Obama's Regulatory Reform become statutes, hedge funds will be subject to extensive disclosure requirements. *See* Hedge Fund Transparency Act, S. 344, 111th Cong. (2009); Hedge Fund Adviser Registration Act, H.R. 711, 111th Cong. (2009); Private Fund Transparency Act, S. 1276, 111th Cong. (2009).

10. FRANKEL & KIRSCH, *supra* note 2, at 161 ("Hedge funds are not subject to borrowing or leverage restrictions that apply to registered investment companies. Moreover hedge funds are not subject to the diversification requirements imposed on registered investment companies and therefore may concentrate their portfolio in a handful of investments thereby increasing their potential exposure to market fluctuation."); Press Release, Office of Sen. Grassley, *supra* note 2 ("The compensation system employed by most hedge funds encourages risk taking. Typically, investors agree to pay hedge fund investment managers a management fee of 2 percent of the fund's total assets, plus 20 percent of the fund's profits. The hedge fund managers profit enormously if the fund does well, but due to the guaranteed management fee, get a hefty payment even when the fund underperforms or fails."); PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG TERM CAPITAL MANAGEMENT 5 (1999) [hereinafter PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS], *available at* http://www.ustreas.gov/press/releases/reports/hedgfund.pdf ("Hedge funds' use of leverage, combined with any structured or illiquid positions whose full value cannot be realized in a quick sale, can potentially make them somewhat fragile institutions that are vulnerable to liquidity shocks.").

11. FRANKEL & KIRSCH, *supra* note 2, at 159 (An investment of $100,000 with the Quantum Fund, a hedge fund managed by George Soros, in 1969, would be worth $314

presumeably why hedge fund investors typically agree to pay a fee based on assets under management (1 to 2%), and to a performance fee (usually 20%) based on the hedge fund's annual returns.[12] In addition, hedge fund investors agree to commit their funds for an extended period, in some cases as long as two years.[13] However, most investors do not expect to be exposed to several types of non-market risk stemming from the fraudulent conduct of hedge fund managers. These include fictitious performance disclosure, looting, inflated asset valuation, and conflicts of interests.[14]

A. Fictitious Fund Performance Disclosure

Fund managers provide frequent disclosure documents to their investors: monthly newsletters, account statements, quarterly performance reports, investor calls and annual financial statements.[15] Prospective hedge fund investors are usually given marketing materials that detail the hedge fund's strategy and include data such as fund performance on a monthly, annual and since-inception basis.[16] Most hedge funds hire an independent accountant to audit this fund performance data.[17]

Unscrupulous hedge fund managers engage in fictitious disclosure statements to investors to hide trading losses, cover-up looting, or as part of a Ponzi scheme.[18] For example, a hedge fund manager can enter non-

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million in 2003); PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 10, at 3 ("[R]ecent studies of hedge fund performance have generally found that hedge funds as a group offer greater returns, yet greater risk, than investment benchmarks such as the Standard and Poor's S&P 500 stock index.").

12. FRANKEL & KIRSCH, *supra* note 2, at 161.

13. *Id.*; IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 9, at ix ("Hedge funds typically agree to repurchase their own interests from investors on a limited, periodic basis, such as quarterly, often following an initial "lock-up period" during which time investors are not permitted to liquidate their investments"); *see also* Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323, 327 (2007).

14. *See infra* Parts II.A-II.F.

15. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 9, at 46; Interview with John C. Liu, Director of Public Equities, Indiana Public Employees' Retirement Fund (Aug. 24, 2009) (on file with Fordham Journal of Corporate and Financial Law).

16. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 9, at 46.

17. *See id.* at 57-59.

18. A Ponzi is an "investment swindle in which high profits are promised from

existent profitable trades in his trading software (or enhance real trades),[19] aggregate these trades with real unprofitable trades (or in some cases no trades),[20] and thereby create the illusion of a profitable monthly trading performance. This fictitious superior performance would then be disclosed to current and prospective investors in order to attract new investors,[21] prevent current investors from making an informed decision (i.e. to stay in the fund or withdraw),[22] and enable the hedge fund manager to pay himself a hefty performance bonus at year's end.[23]

Managers who want to show investors audited financials have another hurdle to clear when trying to release fictitious trading performance data, but they can still engage in a variety of fraudulent schemes. For example, they can create their own accounting firm to audit the fund's financials;[24] forge audited financials and represent that they come from a real accountant;[25] provide an honest accountant with

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fictitious sources and early investors are paid off with funds raised from later ones." THE AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 1364 (4th ed. 2000); *see infra* Part II.

19. *See* Saul Hansell, *Big Japanese Bank Says Trader Lost $1.1 Billion on Deals in U.S.*, N.Y. TIMES, Sept. 26, 1995, at A1 (False trades representing $330 million in fictitious profits were entered into Kidder, Peabody & Co.'s computers by Joseph Jett, the head of its government bond trading unit, over a two-year period.).

20. *See* Nicholas Bray & Michael Sesit, *Barings Was Warned Controls Were Lax But Didn't Make Reforms in Singapore*, WALL ST. J., Mar. 2, 1995, at A3 (trader entered fictitious offsetting trades to make it appear that his real trades were hedged); *see also* David Gow, *SocGen Rogue Trader May Have Had Accomplice, Says Internal Inquiry*, GUARDIAN, May 24, 2008, at 36 (stating that fictitious trades were entered into trading software by rogue trader to disguise his suspect positions).

21. Interview with John C. Liu, *supra* note 15 (Institutional investors look at several factors in order to evaluate an investment in a hedge fund. These factors include the recent performance history of the fund and performance of the fund over an entire market cycle.).

22. *Id.* (When hedge fund managers fictitiously enhance their returns, investors that would have left due to the poor returns by the fund could now be compelled to stay in the fund.).

23. *See* Complaint at 33, Comm. v. Bayou Group, LLC, No. 06 Civ. 2379 (S.D.N.Y Mar. 27, 2006) [hereinafter Committee Complaint].

24. *Id.* at 30.

25. *See* Complaint at 37, SEC v. Nicholson, No. 09 Civ. 1748 (S.D.N.Y Feb. 25, 2009) [hereinafter Nicholson Complaint].

fictitious trading data with forged brokerage reports to back it up;[26] or hire a small auditor who is unduly influenced by the manager.[27]

B. Looting

Looting occurs when a manager transfers cash from the hedge fund to his personal account or third parties for personal expenses.[28] This is usually followed by fictitious disclosure statements to conceal the fraudulent looting.[29] Looting is accomplished in various ways, the most obvious being when a manager wires money out of the hedge fund into his personal bank account and flees the country.[30] There are, however, more subtle examples of looting. For example, a manager could purport to borrow from the fund by signing a promissory note.[31] The promissory note is then entered as an asset on the hedge fund's balance sheet, although it will probably never be repaid by the unscrupulous hedge fund manager. Even if the manager genuinely believes that he will be able to repay the loan when his outstanding trading generates huge incentive fees, the investors' assets have been looted.

Another subtle looting issue arises from fictitious disclosures to investors. Most hedge funds charge investors a 20% performance fee based on the fund's annual returns.[32] Managers that artificially enhance their returns through fictitious trading can therefore earn huge performance based bonuses.[33]

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26. *See* Complaint at 31, SEC v. K.L. Group, No. 05 Civ. 80186 (S.D. Fla. Mar. 2, 2005) [hereinafter KL Complaint].

27. *See* A.C. Thompson & Jake Bernstein, *Toothless Watchdogs? Auditing the Audit Firms*, BARRON'S, May 11, 2009, at 24 (small auditors who earn a significant portion of their annual income from a fund manager might be less willing to do a thorough audit).

28. Zachery Kouwe, *2 Money Managers Held in New Wall St. Fraud Case*, N.Y. TIMES, Feb. 26, 2009, at B5.

29. *Id.*

30. Julie Creswell, *Paradise and Money Lost*, N.Y. TIMES, Aug. 14, 2005, at § 3.

31. *See* Kouwe, *supra* note 28.

32. FRANKEL & KIRSCH, *supra* note 2, at 161.

33. *See* Press Release, SEC, SEC Charges Samuel Israel III, Daniel E. Marino, Bayou Management, and Bayou for Defrauding Hedge Fund Investors and Misappropriating Investor Assets (Sept. 29, 2005), *available at* http://www.sec.gov/news/press/2005-139.htm.

C. Inflated Valuations of Assets

A more subtle hedge fund fraud occurs when hedge fund managers intentionally mismark the value of their hedge fund's assets to inflate its net asset value ("NAV")[34] and performance.

Fraudulent hedge fund managers inflate their fund's NAV in various ways. For example, a hedge fund manager can purchase illiquid stocks and inflate their prices through manipulative trading practices. Following the period in which the manager reports his fund's performance, the manager can purchase blocks of illiquid stocks at steadily increasing prices, thus raising the closing price of the particular stock. The stock's inflated closing price is then used to mark the asset to market,[35] which increases the hedge fund's NAV. A manager could also tout these illiquid stocks in blogs and other public media with the intent to persuade other investors to buy them and raise the price.[36]

Hedge fund managers desiring to inflate their fund's NAV can also invest in asset classes that are inherently difficult to value: stock in

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34. Net asset value (NAV) is computed by taking the market value at the time of all portfolio securities, adding the value of other assets and subtracting liabilities. United States v. Cartwright, 411 U.S. 546, 548 (1973). The net asset value per share (NAV) is computed by dividing the NAV by the number of shares outstanding. *Id.*

35. Mark-to-market is the discipline of periodically valuing assets at current market prices. PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 10, at 4.

36. SEC, Microcap Stock: A Guide for Investors, http://www.sec.gov/investor/pubs/microcapstock.htm (last visited Oct. 17, 2009) ("Fraudsters often use aliases on Internet bulletin boards and chat rooms to hide their identities and post messages urging investors to buy stock in microcap companies based on supposedly 'inside' information about impending developments at the companies."). *See also* Investopedia.com, Pump and Dump, http://www.investopedia.com/terms/p/pumpanddump.asp.

> A scheme that attempts to boost the price of a stock through recommendations based on false, misleading or greatly exaggerated statements. The perpetrators of this scheme, who already have an established position in the company's stock, sell their positions after the hype has led to a higher share price. This practice is illegal based on securities law and can lead to heavy fines. The victims of this scheme will often lose a considerable amount of their investment as the stock often falls back down after the process is complete.

Id. See generally David Kesmodel, *Whole Foods Is Hot, Wild Oats a Dud—So Said 'Rahodeb'*, WALL ST. J., July 12, 2007, at A1 (An example of using blogs to influence stock prices is discussed in this article. Rahodeb was the online pseudonym of John Mackey co-founder and chief executive of Whole Foods Market Inc. After Rahodeb made disparaging remarks and outlandish predictions that Wild Oats stock would fall below $5 a share on Internet message boards, Whole Foods Market Inc. agreed to buy Wild Oats for $565 million, or $18.50 a share.).

privately-held companies, complex structured products[37] and exotic derivatives.[38] These difficult to value investments are marked at prices unjustified by the fundamentals of the investment. Managers will often use unrealistic projections for the pricing models to justify their valuations. Even the value of simpler derivative products, such as over-the-counter ("OTC") equity options, can be inflated by inputting overly aggressive volatility values[39] into a commonly used pricing model, such as the Black-Scholes pricing model.[40] Whichever scheme the manager chooses, the hedge fund's disclosed, audited NAV is significantly higher than its actual value.

D. Conflicts of Interest

Hedge fund managers can place their personal interest ahead of their investors in myriad ways. Managers can assume risks that maximize their expected compensation but are inappropriate for their investors.[41] Furthermore, the hedge fund managers can engage in un-

37. Structured Products are "investment[s] made up of a portfolio of securities and derivatives. A structured product can be customized by the investor, and since payoffs and components vary and contain no standards from product to product, an investor must acknowledge the risk in these investments." Investorwords.com, Structured Product, http://www.investorwords.com/6938/structured_product.html (last visited Oct. 17, 2009).

38. "Exotic derivatives may take many forms. One example is a derivative created by mixing and matching option and forward contracts and whose payoff is a complicated function of one or many underlying securities. For example, a binary option might pay $10 million if, before a specified date, one of the three largest banks in Indonesia has defaulted on its debt." Luciana Aquino-Hagedorn, *Is There a Future in Obtaining and Leveraging Derivatives Patents?*, 125 BANKING L.J. 365, 369 (2008).

39. Shaev v. Hampel, No. 99 Civ. 10578, 2002 U.S. Dist. LEXIS 20497, at *20 (S.D.N.Y. Oct. 25, 2002) ("The Proxy Statement explicitly warns stockholders that the Black-Scholes calculations are estimates, and that the values derived are dependent upon certain (enumerated) assumptions.").

40. The Black-Scholes Option Pricing Method is a common option-pricing method first developed in 1973 by Fischer Black and Myron Scholes. Martino-Catt v. E.I. Dupont de Nemours, No. 4-02-CV-90500, 2002 U.S. Dist. LEXIS 25743, at *5 n.3 (S.D Iowa Feb. 20, 2002). The Black-Scholes pricing model takes into account stock price, expiration date, risk-free rate of return, and stock volatility relative to the marketplace. *Id.* at *8. As is true with all forward looking statements it is inherently speculative. *Id.* at **6-13.

41. Press Release, Office of Sen. Grassley, *supra* note 2 ("Long-Term Capital Management (LTCM) was a hedge fund that, at its peak, had more than $125 billion in

scrupulous and illegal trading practices that place their interest ahead of their investors: front running;[42] cross trading;[43] aggregation;[44] or unfairly allocating profitable trades,[45] among other practices. Additionally, hedge fund managers can execute the majority of their fund's trades with a broker owned or affiliated with the manager with the intent to churn,[46] and/or pay inflated commission.[47] Other conflicts of interest

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assets under management and, due to massive borrowing, a total market position of roughly $1.3 trillion.").

42. Front running occurs when a manager executes an order on a security for his own account prior to executing a significantly larger order on the same security for the fund. The order for the fund will predictably affect the price of the security, and the manager could expect to close out his position at a profit. *See* SEC v. Pasternak, 561 F. Supp. 2d 459, 481, 503, 507 (D.N.J. 2008).

43. Cross trading is a practice that occurs when a broker executes both a buy and a sell for the same security from one client account to another where both accounts are managed by the same portfolio manager. "Typically, this is yet another way for a broker to rip you off. When the trade doesn't get recorded through the exchange, there is a good chance that one client didn't get the best price." Investopedia.com, Cross Trade, http://www.investopedia.com/terms/c/crosstrade.asp (last visited Oct. 17, 2009).

44. *See In re* Kemper Fin. Servs., Inc., Investment Advisers Act Release No. 1387, 51 S.E.C. 715 (Oct. 20, 1993) (Kemper aggregated trades and then allocated the execution price in order to benefit certain clients over others. Section 17(d) of the Investment Company Act and Rule 17d-1(a) prohibit fraudulent practices in connection with aggregated trades in which an investment company and affiliated persons of the investment company participate.).

45. *In re* Walker Inv. Manager, Inc., 52 S.E.C. 865 (1996) (An example of unfair allocations of profitable trades is discussed in this proceeding. Walker, an investment manager, had approximately 33 accounts with over $300 million in assets under management. Walker favored performance-based fee clients when allocating profitable equity trades, a practice he failed to disclose to his clients.).

46. "Churning refers to the excessive buying and selling of securities in your account by your broker, for the purpose of generating commissions and without regard to your investment objectives. Churning can be a violation of SEC Rule 15c1-7 and other securities laws." SEC, Churning http://www.sec.gov/answers/churning.htm (last visited Oct. 17, 2009). *See also* I.R.C. § 1 (2006) (Not only does unnecessary trading generate significant commissions for the broker to the detriment of the investor, but assuming that the trades are profitable it also creates short term gains that are taxed as ordinary income to the investor. Under the current United States federal tax system, positions held for more than one year would be treated as capital gains with a significantly better tax treatment.).

47. *In re* Bayou Group, LLC, 39 B.R. 810, 822 (Bankr. S.D.N.Y. 2008) (Bayou Securities was wholly owned by Israel and was used to execute the vast majority of the trades done by the Bayou Group's hedge funds, also managed by Israel. In 2003, Bayou Securities earned an estimated $29 million in trading commissions, while the Bayou Funds with possibly $400 million in assets lost an estimated $49 million.).

include the employment of small auditors who derive a significant income from the manager[48] and soft dollar commissions.[49]

II. HEDGE FUND FRAUDS

Samuel Israel—The Bayou Group (Disclosure, Looting & Conflicts of Interest)

Samuel Israel III came from a wealthy family and worked at various Wall Street firms during the 1980s and early 1990s, including the prestigious multibillion-dollar Omega hedge fund.[50] In June 1996, he founded the Bayou Group and opened his first hedge fund, the Bayou Fund.[51] His Wall Street pedigree and charm, coupled with a low threshold for an initial investment and the absence of a customary

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48. *See* Thompson & Bernstein, *supra* note 27. *See also* Complaint at 22, Romberger v. Irwin, No. 09-01266 (E.D. Pa. Mar. 23, 2009) (alleging that the fraud could not have been perpetrated without the reckless and or negligent actions of the fund's accountant).

49. Soft dollars is an arrangement under which products or services other than the execution of securities transactions are obtained by a manager from a broker-dealer in exchange for using that broker to execute trades. During routine inspections of advisers and broker-dealers, the SEC has found the following examples of products or services acquired: advisers using soft dollars to pay for office rent and equipment, cellular phone services and personal expenses, advisers using soft dollars to pay an employee's salary, an adviser using soft dollars to pay for advisory client referrals and marketing expenses, an adviser using soft dollars to pay legal expenses, hotel and rental car costs and to install a phone system, and an unregistered hedge fund adviser using soft dollars to pay for personal travel, entertainment, limousine, interior design and construction expenses. Registered Investment Companies generally comply with the limitations detailed in Section 28(e) of the Securities Exchange Act of 1934, but hedge funds, which are generally not registered, are not subject to the limitations of Section 28(e) and thus the client commissions are not necessarily used for the direct benefit of the client. *See generally* OFFICE OF COMPLIANCE, INSPECTIONS AND EXAMINATIONS, SEC, INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS (1998).

50. Nelson D. Schwartz & Abha Bhattarai, *The Search for a Missing Trader Goes Global*, N.Y. TIMES, June 14, 2008, at C1 (According to former colleagues, Israel exaggerated his role at Omega. Rather than being a head trader, he was more of an administrator.).

51. Committee Complaint, *supra* note 23, at 21.

management fee, most likely attracted his initial investors.[52] Israel eventually added several other hedge funds to his Bayou Group. Over time his consistently low risk and high market returns[53] attracted an estimated $450 million from investors.[54] Israel traded these assets through accounts maintained by Bayou Securities, a broker-dealer owned by Mr. Israel.[55] Bayou Securities was registered with the SEC and was a member of the National Association of Securities Dealers ("NASD").[56]

Following its first year of trading, Israel's hedge fund failed to meet its profit targets. Israel then concealed his poor trading performance by transferring trading commissions paid to Bayou Securities back to the Bayou Fund. As a result, both current and potential investors were misled into thinking that Israel had a strong trading performance that year.[57] His trading performance continued to decline and in 1998 the Bayou Fund sustained millions of dollars in losses.[58] To cover up these losses Israel created fictitious trading statements and reports for his investors with the help of his Chief Financial Officer, Daniel Marino.[59] Israel used this false trading performance to create fake annual financial statements.[60] Aware that he could not deceive an independent auditor with these false financial statements, Israel dismissed the fund's accounting firm and hired a fictitious accounting firm, Richmond-Fairfield Associates.[61] Israel created this fictitious firm, and its sole principal was Marino. It purported to prepare "independent" audit reports that validated Bayou's financials.[62]

From 1999 until the firm's closing in 2005, the Bayou hedge funds continued to lose money.[63] Israel concealed these losses by issuing newsletters, monthly account statements, quarterly reports and annual

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52. Amanda Cantrell, *What Happened at Bayou*, CNNMONEY, Sept. 29, 2005, http://money.cnn.com/2005/09/29/markets/bayou_investors/index.htm.

53. Committee Complaint, *supra* note 23, at 23.

54. *Id.*

55. *Id.* at 15, 24.

56. *Id.* at 11.

57. *Id.* at 28.

58. *Id.* at 29.

59. Committee Complaint, *supra* note 23, at 29.

60. *Id.* at 30.

61. *In re* Bayou Group, LLC, 39 B.R. 810, 822 (Bankr. S.D.N.Y. 2008).

62. *Id.*

63. Committee Complaint, *supra* note 23, at 31.

financials that falsely claimed that the funds were profitable.[64] These reports were then validated by Richmond-Fairfield Associates' "independent" audits.[65]

In addition to losing investors' money through poor trading, Israel looted the fund through two mechanisms. First, he traded extensively. The majority of these trades were executed by Bayou Securities, earning him hefty commissions.[66] For example, in 2003 Bayou Securities earned an estimated $29 million in commissions, which were distributed to Israel as salary and profits.[67] Second, Israel withdrew substantial annual performance fees based on his fictitious trading performance.[68]

By 2004, Israel was unable to garner enough cash from new investors to balance cash outflows from his hedge fund's trading losses, commissions, and performance fees.[69] At this point, Israel stopped trading, liquidated the hedge funds, and transferred the cash to various personal bank accounts.[70] In July 2005, Israel informed his investors that Bayou was closing and that they would receive 100% of their investment, yet his investors had still received nothing by August 2005,[71] and the SEC caught on to the scheme.[72]

Greenwood & Walsh—Westridge Capital (Disclosure, Looting & Conflicts of Interest)

Messrs. Greenwood and Walsh became famous in the 1980s by devising a computerized trading program called Shark that allowed traders to spot trading opportunities in various assets.[73] They parlayed this fame, as supposed Wall Street wizards, into their Westridge Capital venture. They solicited institutional investors by promising to invest their money in an "enhanced equity indexing" strategy.[74] This was

64. In re *Bayou Group LLC*, 39 B.R. at 822.
65. Committee Complaint, *supra* note 23, at 30-31.
66. *Id.* at 33.
67. *Id.*
68. *Id.* at 34.
69. Motion for Judgment by Plaintiffs at C, *In re* Bayou Hedge Funds Inv. Litig., No. 06 Civ. 3026 (S.D.N.Y. June 15, 2007).
70. *Id.*
71. Committee Complaint, *supra* note 23, at 37.
72. Cantrell, *supra* note 52.
73. Kouwe, *supra* note 28.
74. Complaint at 21, SEC v. WG Trading Investors, L.P., No. 09 Civ. 1750

ostensibly a low risk strategy designed to outperform major market indexes.[75]

Enhanced equity indexing is a broad term that describes various low risk strategies designed to outperform traditional indexing.[76] Westgate's approach consisted of two components.[77] In the first phase, Westgate would gain exposure to a stock index, such as the S&P 500, through the purchase of S&P 500 index futures.[78] In the second phase, Westgate would execute an index arbitrage strategy[79] to lock in a cash flow. Westgate accomplished this arbitrage by selling index futures short and buying the underlying equities in the index or vice versa depending on market conditions.[80] The combination of Westgate's futures position in the S&P 500 coupled with the arbitrage cash flow produced an enhanced S&P 500 return.

From 1996 until their scheme unraveled in February 2009, Westridge Capital and its affiliated entities raised over $667 million.[81] Greenwood and Walsh invested only a fraction of this money, however, in the enhanced equity indexing strategy.[82] Instead, they treated Westridge like their personal piggy-bank and misappropriated as much as $554 million to fund their lavish lifestyles.[83] Indeed, Greenwood and Walsh went on a spending spree: they bought luxury cars, multi-million dollar homes, a horse farm, horses, and incredibly, an $80,000 teddy bear collection.[84] They effected their looting by simply instructing employees to wire funds from Westridge to their personal accounts or in some cases to third parties to cover personal expenses.[85] Moreover, they

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(S.D.N.Y. Feb. 25, 2009) [hereinafter WG Complaint].

75. Stecklow, *supra* note 3.

76. Indexing is a strategy where a manager builds a portfolio of securities to mimic an index. FRANK K. REILLY, INVESTMENT ANALYSIS AND PORTFOLIO MANAGEMENT 232 (1994). Enhanced indexing is considered a hybrid between active and passive management and is used to describe any strategy that is used in conjunction with indexing for the purpose of outperforming a specific benchmark. Investopedia.com, Enhanced Indexing, http://www.investopedia.com/terms/e/enhanced-indexing.asp (last visited Oct. 18, 2009).

77. WG Complaint, *supra* note 74, at 7.

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.* at 2.

82. *Id.*

83. WG Complaint, *supra* note 74, at 2.

84. Kouwe, *supra* note 29.

85. WG Complaint, *supra* note 74, at 11.

would annually sign "promissory notes" with no interest or maturity to cover their withdrawals.[86] The scheme unraveled in February of 2009 during an audit by the National Futures Association ("NFA")[87] when the NFA discovered the notes and requested a meeting with Greenwood and Walsh. They refused to cooperate and the NFA suspended their membership.[88] As institutional investors learned of the suspension, requests for withdrawals began and Westridge imploded.

Kim—The KL Group
(Disclosure & Looting)

When marketers of the KL Group would meet with investors, they touted John Kim's history as a highly profitable Wall Street trader with a sophisticated proprietary trading system.[89] KL Group marketers would lead prospective investors through the KL Group's luxurious offices in the new Esperante building in downtown West Palm Beach, Florida. These tours would culminate with a visit to the KL Group's trading floor,[90] a technological marvel with large flat-panel televisions scattered throughout.[91] There were hordes of traders on the phone and Kim, the main attraction, frantically trading while surrounded by 20 computer screens.[92]

Kim and the other two principals of the firm drove flashy cars, lived lavish lifestyles and befriended the right people who introduced them to wealthy Palm Beach clients.[93] Marketing materials boasted that the fund achieved an annualized return in excess of 125% by investing in aggressive growth stocks.[94] The purported success of the fund and its aura of exclusivity had Palm Beach's elite begging to be let in the fund.

In fact, Kim had no Wall Street experience[95] and the fund had

86. *Id.* at 11-12.
87. The National Futures Association is a self-regulating organization for the United States futures industry. *See* National Futures Association, www.nfa.futures.org (last visited Oct. 17, 2009).
88. WG Complaint, *supra* note 74, at 33.
89. KL Complaint, *supra* note 26, at 7.
90. Julie Creswell, *supra* note 30.
91. *Id.*
92. *Id.*
93. *Id.*
94. KL Complaint, *supra* note 26, at 8.
95. *Id.*

sustained massive losses of approximately $81 million.[96] The hordes of traders who populated the floor were inexperienced and spent their days trading inconsequential sums of money to give the appearance of a legitimate trading floor.[97] To conceal these losses, Kim and the two other principals forged brokerage reports to fool the firm's independent accountant.[98] The accountant then generated account statements and other performance disclosures that were given to investors to conceal the losses.[99] Once the principals at KL Group realized that they could not recoup their massive trading losses, two of them looted cash from the fund and fled the U.S. [100] Both were eventually captured a few years later and brought back to Palm Beach County for prosecution.[101]

Lauer—Lancer Management Group (Disclosure & Inflated Valuations)

Michael Lauer was an established investment manager who raised over $1.1 billion from wealthy individuals and large institutions for his Lancer family of hedge funds.[102] His trading strategy, as he explained it, focused on investments in small and mid-cap companies that Wall Street had shown little or no interest in.[103] In fact, Lauer took advantage of these stocks' illiquidity and inflated their prices through manipulative trading.[104] Near the close of the last trading day of the month, Lauer would buy blocks of these illiquid stocks at steadily increasing prices, to raise their closing price.[105] In addition, Lauer purchased stocks in privately held companies and gave them unjustified high prices based on

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96. *Id.*
97. Creswell, *supra* note 30.
98. *Id.* at 30.
99. *Id.* at 32.
100. Jim Loney, *Partner in $200 Million Fund Collapse Faces U.S. Court*, REUTERS, Apr. 3, 2009, *available at* http://www.reuters.com/article/rbssInvestmentServices/idUSN0335514220090403.
101. Jason Schultz, *Lawyer Pleads Guilty to Fraud*, PALM BEACH POST, Sept. 17, 2009, at 6B.
102. Press Release, SEC, SEC Wins Major Hedge Fund Fraud Case Against Michael Lauer, Head of Lancer Management Group (Sept. 24, 2008), *available at* http://www.sec.gov/news/press/2008/2008-225.htm [hereinafter Lauer Press Release].
103. Complaint at 5, SEC v. Lauer, No. 03-80612 (S.D. Fla. Feb. 25, 2009) [hereinafter Lauer Complaint].
104. *Id.* at 22.
105. *Id.*

unrealistic projections.[106] The mismarking of assets allowed him to claim a significantly higher NAV for his fund, translating into a highly inflated fund performance. With his "phenomenal" trading, Lauer reaped ten of millions in performance fees, attracted new investors and ensured that his current investors stayed in the fund.[107] Lauer's mark-to-market method even convinced his auditors, who certified Lauer's end of year financial statements based on Lauer's lofty valuations.[108] When news that the SEC was investigating the fund surfaced, investors began to request redemptions. Lauer was forced to sell overpriced, illiquid assets, triggering massive losses.[109] Indeed, Lauer's fraud cost investors an estimated $500 million.[110]

Nicholson—Westgate
(Disclosure & Looting)

James Nicholson worked for years as a registered representative at various broker-dealers. Following numerous customer complaints, he was permanently barred from the industry by the NASD.[111] He then founded Westgate Capital Management.[112] The fund's strategy was touted as one that would exploit perceived anomalies in the prices of equities (known as a long/short strategy).[113] The fund would buy stocks that it perceived to be underpriced while selling stocks that it believed to be overpriced so that it would achieve positive returns in all market

106. *Id.* at 17.

107. *Id.* at 2.

108. Lauer Complaint, *supra* note 103, at 34.

109. *Fund Manager Liable for Fraud*, WALL ST. J., Sept 25, 2008, at C12; Ann Logue, Lancer Management Group—Penny Stocks (Fraudulent), Hedgefund Implode-O-Meter, http://hf-implode.com/imploded/fund_LancerManagementGroup_2003-07.html (last visited Oct. 17, 2009).

110. Lauer Press Release, *supra* note 102.

111. Nicholson Complaint, *supra* note 25, at 6 (James Nicholson was permanently barred as a registered representative of the National Association of Securities Dealers in 2001.).

112. *Id.* at 7.

113. Long/short involves creating a portfolio that consists of buying equities that are expected to increase in value and selling equities that are expected to decrease in value. No matter what happens in the overall market, as long as the spread between the purchased and sold equities is favorable, the fund profits. PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *supra* note 10, at 11-12.

conditions.[114] With alleged steady positive returns in all months, leading to annual returns in the vicinity of 20%, he was able to raise approximately $294 million from investors.[115] Nicholson's trading strategy might have initially been effective but eventually he started to lose money.[116] However, he disclosed to investors that his fund was profitable. He then stole the identity of accountant Ron Havener and set up a fictitious accounting firm named Havener & Havener (with a prestigious Manhattan address[117]) to audit the fund.[118] The accounting firm provided investors with audited financials to corroborate Westgate's fictitious disclosures.[119] His scheme dissolved as news of Bernard Madoff's arrest,[120] coupled with the stock market's collapse, scared investors. Soon, requests for withdrawals mounted.[121] Redemption checks bounced and shortly thereafter regulators were knocking at his door.[122] The fraud cost investors at least $150 million.[123]

Nadel—Scoop
(Disclosure & Looting)

According to his fund marketing documents, Arthur Nadel graduated from New York University Law School and was a prominent real estate developer during the 1960s.[124] These documents failed to disclose, however, that Nadel was disbarred in 1982 for taking $50,000

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114. Nicholson Complaint, *supra* note 25, at 25.

115. *Id.* at 26-29; Andrew Tangel et al., *Investors Say Charm Lured Them into Ruin*, RECORD, July 19, 2009, at A01.

116. Nicholson Complaint, *supra* note 25, at 27.

117. *Id.* at 37 (Nicholson personally set up this front at 49 East 41st Street, New York, New York through a virtual office arrangement, using his own telephone numbers and driver's license.).

118. *Id.*

119. *Id.*

120. SEC, Litigation Release No. 20889, Defendant Bernard L. Madoff Consents to Partial Judgment Imposing Permanent Injunction and Continuing Other Relief (Feb. 9, 2009), *available at* http://www.sec.gov/litigation/litreleases/2009/lr20889.htm (complaint alleges that Bernard Madoff committed a $50 billion fraud).

121. Nicholson Complaint, *supra* note 26, at 38-42.

122. *Id.*

123. Chad Bray, *Two Indicted on Charges Tied to Fraud*, WALL ST. J., Apr. 24, 2009, at C3.

124. Complaint at 1, SEC v. Nadel, No. 09-00087 (M.D. Fla. Jan. 21, 2009) [hereinafter Nadel Complaint].

out of an escrow account to pay off loan sharks.[125]

In 2001, Nadel opened an investment management company that eventually advised six hedge funds.[126] His stated trading strategy was to input extensive fundamental equity research into a proprietary computerized trading system.[127] With the strong trading record allegedly produced by his "black box," he raised $397 million over time from gullible investors.[128] Unfortunately, there was no trading because Nadel ran a Ponzi scheme. Nadel used new cash entering his funds to pay previous investors, or simply transferred the money to his secret personal bank accounts.[129] When the SEC began to investigate his funds, he provided investigators false financials showing assets in excess of $300 million.[130] A few months later, when the SEC filed an emergency action against Nadel, it found less than $1 million in the firm's accounts.[131]

III. DISCLOSURE VS. THIRD PARTY OVERSIGHT

Disclosure is the foundation of the federal securities laws in the United States.[132] In response to the stock market crash of 1929, Congress enacted laws designed to protect current and potential investors. The Securities Act of 1933 (the "'33 Act") governs the registration and sale of securities and related disclosure requirements. The '33 Act requires issuers to disclose significant information about themselves and the terms of the securities they are issuing.[133] The Securities and Exchange Act of 1934 (the "'34 Act") regulates secondary markets and many market participants. It requires the Regis-

125. Debra Cassens Weiss, *Latest Missing Money Manager Was a Disbarred Lawyer*, A.B.A. J., Jan. 22, 2009, http://www.abajournal.com/news/latest_missing_money_manager_was_a_disbarred_lawyer.

126. Nadel Complaint, *supra* note 124, at 1.

127. Michael Pollick, *Nadel Denies SEC Allegations*, SARASOTA HERALD-TRIB., Apr. 7, 2009, at D01.

128. *Id.*

129. Nadel Complaint, *supra* note 124, at 5.

130. *Id.* at 36-38.

131. *Id.*

132. Interview with James Jalil, *supra* note 4; *see also* SEC, The Laws That Govern the Securities Industry, http://www.sec.gov/about/laws.shtml (last visited Oct. 17, 2009).

133. Securities Act of 1933, 15 U.S.C. § 77j (2006).

tration of all securities that are to be traded on a securities exchange and detailed disclosures regarding both the company and the registered security.[134] In addition to the initial registration, the '34 Act also requires publicly traded companies to report certain material information to the public periodically.[135] Similarly, under the Investment Company Act of 1940, investment companies subject to the Act must register with the SEC, which imposes disclosure requirements and some direct regulation.[136] These laws are supposed to allow investors to make informed decisions based on full and complete disclosure by issuers and publicly traded companies.

The reasoning supporting these acts is clear: disclosure discourages misconduct. As Justice Louis Brandeis famously wrote, "sunlight is the best disinfectant."[137] With this legislative history of registration and disclosure, it is logical that politicians now believe that disclosure is the solution to hedge fund fraud. As Senator Chuck Grassley stated, it is time to "shed some sunlight on [hedge funds] to see what they're up to."[138]

If only it were so easy. As the frauds discussed above demonstrate, even sophisticated parties[139] can be fooled. For this reason, it is unlikely that disclosure will sufficiently prevent hedge fund fraud in the future.

A. Why Disclosure Will Not Work

An investment adviser registers with the SEC by filing a document called Form ADV.[140] Part 1 of the form requires disclosure of information pertaining to the adviser.[141] It includes the adviser's education, business and disciplinary history within the last ten years, address, phone number, number of employees, types of clients, assets under

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134. Securities Exchange Act of 1934, 15 U.S.C. § 781 (2006).

135. *Id.*

136. Investment Company Act of 1940, 15 U.S.C. §§ 80a1-80a64 (2006).

137. Securities Industry and Financial Markets Association, Securities Act of 1933, http://www.sifma.org/legislative/sec_exchange_act_of_1933.html (last visited Oct. 17, 2009).

138. Press Release, Office of Sen. Grassley, *supra* note 2.

139. In both the *Westridge Capital* and *Lancer* cases, institutional investors were fooled. *See generally supra* text Part II.B, II.D.

140. SEC, Form ADV, http://www.sec.gov/answers/formadv.htm (last visited Oct. 17, 2009).

141. *Id.*

management, ownership information, and key executives.[142] Part 1 is filed electronically with the SEC.[143] Investors can find a copy of an investment adviser's most recent Part 1 on the Investment Adviser Public Disclosure Web site.[144] Part 2 is a narrative document that includes additional information such as an adviser's services, fees, business practices and investment strategies.[145] The adviser is required to maintain and deliver Part 2 to clients and prospective clients.[146]

This Note discussed the numerous ways that hedge fund managers can manipulate disclosure: blatant lying to investors and auditors,[147] the creation of fictitious accounting firms to audit financials,[148] identity theft and forged audited financials,[149] forged trading documents provided to legitimate auditors,[150] and fanciful valuations of private companies and illiquid stocks.[151] Any hedge fund manager engaging in these activities would undoubtedly provide the SEC and investors with a false or misleading Form ADV.[152] Moreover, can the SEC, with its current manpower, even effectively review the accuracy of Form ADV of over 8000 hedge funds?[153]

Some fraudsters were registered as investment advisers with the SEC. That did not stop them from perpetrating their fraud. For example, the managers at Westridge Capital Management, a registered investment adviser, made fictitious disclosures and looted as much as $554 million from their fund.[154] Madoff registered Bernard L. Madoff Securities LLC as an investment adviser with the SEC in 2006,[155] yet

142. *Id.*

143. *Id.*

144. SEC, Investment Adviser Public Disclosure, http://www.adviserinfo.sec.gov/IAPD/Content/IapdMain/iapd_SiteMap.aspx (last visited Oct. 17, 2009).

145. *See* SEC, Form ADV, *supra* note 140.

146. *Id.*

147. *See supra* Part II.B.

148. *See supra* Part II.A.

149. *See supra* Part II.E.

150. *See supra* Part II.C.

151. *See supra* Part II.D.

152. *See* SEC, Form ADV, *supra* note 140.

153. Press Release, Hedge Fund Research Inc., Record Number of Hedge Funds Liquidate in 2008 (Mar. 18, 2009), *available at* https://www.hedgefundresearch.com/pdf/pr_20090318.pdf.

154. *See supra* text Part II.B.

155. Transcript of Guilty Plea at 10-13, United States v. Madoff, No. 09 CR 213 (S.D.N.Y Mar. 12, 2009).

still continued to perpetrate the largest investor fraud ever committed by a single person. R. Allen Stanford orchestrated an $8 billion fraud through Stanford Capital Management, a registered investment adviser.[156] This suggests not only that registration was ineffective, but also that it might actually help perpetrate the fraud. Investors might assume a registered hedge fund has an implicit SEC approval. This could make it easier for an unscrupulous manager who intends to run a Ponzi scheme to raise funds.

Similarly, despite extensive disclosure requirements for public companies,[157] vigorously enforced by the SEC, the U.S. has still experienced a series of disclosure-based scandals[158] in the last decade from major corporations such as WorldCom,[159] Tyco International,[160] Global Crossing,[161] Adelphia Communications[162] and, of course,

156. Amended Complaint at 1, SEC v. Stanford Int'l Bank, Ltd., No. 09-0298 (N.D. Tex. Feb. 17, 2009) (Stanford and Davis executed a massive Ponzi scheme through entities under their control, including Stanford International Bank, Stanford Group Company, a broker dealer, and Stanford Capital Management, an investment adviser.).

157. *See* 15 U.S.C. § 77j (2006); 15 U.S.C. § 781 (2006).

158. Ohio Pub. Employees Ret. Sys. v. Fannie Mae, 357 F. Supp. 2d 1027, 1030 (S.D. Ohio 2005) (2004 accounting scandal at Fannie Mae); United States v. Brown, 338 F. Supp. 2d 552, 557-59 (M.D. Pa. 2004) (2002 accounting scandal); SEC, Litigation Release No. 21090, SEC Sues Comverse Technology, Inc. for Fraudulent Options Backdating and Earning Management Schemes (June 18, 2009), *available at* http://www.sec.gov/litigation/litreleases/2009/lr21090.htm; Press Release, Fed. Bureau of Investigation, San Diego, Peregrine's Former European Vice President Pleads Guilty to Wire Fraud (Jan. 26, 2009), *available at* http://sandiego.fbi.gov/dojpressrel/pressrel09/sd012609.htm (2002 accounting scandal); SEC, Litigation Release No. 20836, SEC Files Settled Enforcement Actions Against UnitedHealth Group Inc. and Former General Counsel in Stock Options Backdating Case (Dec. 22, 2008), *available at* http://www.sec.gov/litigation/litreleases/2008/lr20836.htm; SEC, Litigation Release No. 20717, SEC Announces $7.2 Million Settlement With Former KB Home Chairman and CEO for Stock Option Backdating and Self-Dealing (Sept. 15, 2008), *available at* http://www.sec.gov/litigation/litreleases/2008/lr20717.htm (CEO of KB Homes charged with backdating of options); Chris Noon, *RadioShack's Edmonson Apologizes for Resume Flubs*, FORBES.COM, Feb. 16, 2006, http://www.forbes.com/2006/02/16/radioshack-edmonson-resume-cx_cn_0216autofacescan11.html (RadioShack's CEO apologizes over misstatements on résumé); David Voreacos, *Rite Aid Ex-Counsel Brown, 76, Wins Delay of 10-Year Jail Term*, BLOOMBERG, Dec. 6, 2004, http://www.bloomberg.com/apps/news?pid=10000103&sid=aFNt8rGBWhe0&refer=us (Executives at Rite Aid Corporation were convicted of inflating earnings at Rite Aid. The fraud led the company to erase $1.6 billion in profit.).

159. SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 431 (S.D.N.Y. 2003).

160. *In re* Tyco Int'l, Ltd., 535 F. Supp. 2d 249, 252 (D.N.H. 2007).

161. *In re* Global Crossing Sec. & ERISA Litig., 225 F.R.D. 436, 441 (S.D.N.Y.

Enron.[163] Some of these frauds have been so extensive that, when discovered, drove those companies into bankruptcy.[164] For example, WorldCom filed for Chapter 11 bankruptcy protection soon after disclosing that Scott D. Sullivan, its Chief Financial Officer, implemented a strategy that improperly accounted for $3.85 billion of expenses.[165] If the extensive disclosure requirements of the '33 and '34 Acts have not prevented executives from manipulating financial statements so that they could reap the benefits of their stock options grants, such measures are unlikely to be effective for hedge funds.[166]

Finally, registration will not prevent a dishonest manager from becoming a looter. Once the principals at KL Group realized that they could not recoup their massive trading losses, two of the principals looted cash from the fund and fled the U.S.[167] This type of looting would not be prevented by disclosure.

B. Independent Third Parties as a Solution to Hedge Fund Fraud

A better way to minimize fraud risk would be to amend the U.S. Investment Company Act of 1940 (the "'40 Act"). The '40 Act defines investment companies and places them under the regulatory oversight of the SEC.[168] The '40 Act focuses on disclosure about funds and their investment objectives, as well as on investment companies' structure

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2004).

162. *In re* Adelphia Commc'ns Corp., 285 B.R. 580, 586 (Bankr. S.D.N.Y. 2002).

163. Newby v. Lay, 258 F. Supp. 2d 576, 611 (S.D. Tex. 2003) (accounting fraud in 2001).

164. *See* Todd R. Weiss, *Troubled Peregrine Files for Chapter 11 bankruptcy*, COMPUTER WORLD, Sept. 23, 2002, http://www.computerworld.com/s/article/74473/Troubled_Peregrine_files_for_Chapter_11_bankruptcy (stating that an accounting scandal forced Peregrine into bankruptcy and resulted in criminal indictments for 11 senior managers); *see also* Simon Romero, *WorldCom's Collapse: The Overview; WorldCom Files for Bankruptcy; Largest U.S. Case*, N.Y. TIMES, July 22, 2002, at A1 (stating that on July 21, 2002, WorldCom filed for Chapter 11 bankruptcy protection in the largest such filing in United States history).

165. Romero, *supra* note 164.

166. Hedge fund managers receive a performance fee (usually 20%) based on the hedge fund's annual returns. FRANKEL & KIRSCH, *supra* note 2, at 161. Therefore they have similar incentives as corporate executives have to inflate their earnings.

167. Loney, *supra* note 100.

168. *See* 15 U.S.C. §§ 80a1-80a64 (2006).

and operations.[169] Compliance with the '40 Act's provisions is burdensome.[170] The most common exemptions (to the definition of an investment company) are found in Sections 3(c)(1)[171] and 3(c)(7)[172] of the '40 Act. These exemptions are most commonly used by hedge funds to escape SEC oversight.

Any hedge fund seeking to utilize Section 3(c)(1) and 3(c)(7) exemptions of the '40 Act [173] should be required to place its securities and similar investments in the custody of an independent third party once the fund exceeds a certain threshold dollar amount.[174] The custodian, known as a fund administrator in the hedge fund industry,[175] would be mandated by the revised Act to perform several duties intended to safeguard investors' assets.

1. Disclosure Duties

Under my proposal, the hedge fund administrator would maintain the fund's financial books and records, calculate the fund's NAV, and provide monthly reports directly to the investors without input from the adviser. The hedge fund would still choose the broker to execute trades, but this choice would be subject to a veto by the fund administrator.[176] Copies of all trade confirmations would be sent to the fund administrator

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169. *See id.*

170. *See id.*

171. *See id.* (The section 3(c)(1) exemption is based on the number of investors, "Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.").

172. *See id.* (The section 3(c)(7) exemption is based on wealthy investors, "[a]ny issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities." A qualified investor is defined in Section 2(51), as natural persons with $5 million in investments, or persons that control $25 million.).

173. *See id.* (By utilizing these exemptions, a hedge fund does not fall under the definition of an investment company and therefore need not register as an investment company and consequently follow the extensive regulations associated with it.).

174. The intent of the threshold is to keep the sector vibrant by not imposing high custody costs on new hedge funds.

175. FundAdministrator.org, Fund Administration Definition, http://fund administration.org/fund-administrator-definition/ (last visited Oct. 17, 2009).

176. The fund administrator could veto the broker for a conflict of interest. For example, an administrator may veto a broker if the broker was owned or controlled by the manager, received most of the trades of the fund, or charged high commissions.

in order to perform daily and monthly reconciliations between the broker and manager. The fund administrator would prepare the semi-annual and annual financials and have the sole responsibility to hire the fund's independent auditor. The qualifications of the auditor would be as stringent as those used for registered investment companies.[177] My proposal would also require the auditor to deliver the fund's audited financials to investors within a reasonable time frame. This would be defined as within 60 days of the end of their fiscal year (the time frame required for registered investment companies).[178]

2. Anti-Looting Duties

Under my proposal, hedge fund investors would send their cash directly to the bank account set up by the fund administrator, rather than to the hedge fund manager or to any accounts controlled by him. The fund administrator would have sole and absolute control of this account. The hedge fund manager would have no ability to withdraw cash from

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177. IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 9, at 57-59.

> The qualifications of an independent accountant that may be used by a hedge fund are not as stringent as those used for registered investment companies. A hedge fund's independent accountant must comply with the general independence standards of the AICPA or of the individual State Boards of Accountancy where the independent accountant practices. In contrast, a registered investment company independent accountant must comply with the requirements of the Investment Company Act of 1940 and is required to follow certain regulations established under the Sarbanes-Oxley Act of 2002 and various Commission rules to ensure the independence of auditors. In addition, a hedge fund's independent accountant is not required to register with the Public Company Accounting Oversight Board ("PCAOB") unless if it also serves as the independent auditor for a public company. A hedge fund's independent auditor is not otherwise required to register with PCAOB, nor are its audits with respect to private issuers subject to PCAOB examination. As a result, the audits of hedge fund financial statements will not be subject to the examination process of the PCAOB in its oversight of registered accounting firms.

Id.

178. Registered investment companies must transmit to shareholders audited financial statements within 60 days of their fiscal year end. *See* 17 C.F.R. § 270.30e-1(c) (2009). *See* IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS, *supra* note 9, at 58 ("There are no time constraints on delivering the hedge fund's audited financial statements to investors unless specifically stated in the PPM or partnership agreement."). *But see* 17 C.F.R. § 275.206(4)-2 (2009) (A registered investment adviser with custody of client assets is required to provide all limited partners or beneficial owners of the hedge fund with audited financial statements within 120 days in certain circumstances.).

the account. The manager's monthly management fee, and annual performance fee would be calculated by the fund administrator and sent to the manager. Clients wishing to redeem would have to contact both the hedge fund manager and the fund administrator, who would then coordinate to send them the cash. In essence, the hedge fund manager would only have trading authority in the fund that he was advising. The fund administrator would handle all other administrative details dealing with cash flows (such as payment of the fund's expenses).

3. Preventing Inflated Valuations of Assets

The fund administrator would be responsible for pricing the securities in the fund. For thinly traded (illiquid) assets, the fund administrator would not accept the end of month closing price as the value for the asset, especially if it significantly deviates from the average value for that month. When pricing these assets the fund administrator would be mandated to take a conservative approach that would take into account factors such as the size of the hedge fund's position in that asset versus its daily trading volume. For the pricing of assets in private companies and other hard-to-price securities that are beyond the ability of the fund administrator to price, independent third parties should be utilized.

In all cases, where a hedge fund's portfolio contains assets that are illiquid, privately held, or otherwise hard to price (e.g., structure products, exotic derivatives), the fund administrator would have to disclose this information (in a prominent fashion), along with associated risks on the periodic reports to investors.

4. Preventing Conflicts of Interest

Not all conflicts of interest would be eliminated through the fund administrator mechanism. The fund administrator realistically would be unable to limit the risk that the fund was taking other than ensuring that purchases of assets were in compliance with the fund's stated objectives in terms of both leverage and asset class. In other areas the fund administrator could be more effective.

The fund administrator would have the authority to request disclosure of broker accounts owned or controlled by the manager (and other principals) and receive monthly copies of statements. The fund administrator's compliance department would monitor these accounts for front-running.[179]

All trades would clear through the fund administrator. This would enable the fund administrator's compliance department to monitor for unusually high broker commissions paid to brokers, and for excessive trading designed to produce commissions.[180]

Trades between funds, trades to be allocated to multiple funds, or aggregation of a trade destined for multiple funds would be flagged and sent to the fund administrator's compliance department for review. The compliance department would determine if any conflicts of interest were present and would discuss the issue with the manager. In the event the fund administrator determined there was a conflict of interest, it would have the authority to re-price the trade (for cross-trading)[181] or split up the trade equally among funds (for aggregation and allocation issues).[182]

If the broker used to execute trades was owned or affiliated with the hedge fund manager (or other fund principals), the fund administrator would disclose this information on the periodic reports to investors.

The fund administrator would also be required to have a "noisy withdrawal" rule. In the event that the fund administrator terminated its duties with a fund it would be required to give its reason to the SEC.

IV. POTENTIAL ISSUES WITH THIRD PARTY CUSTODIANS

Hiring a fund administrator is a significant expense for a hedge fund. Fees charged by administrators are based on a variety of factors including, number of investors, types of assets in the fund, transaction volume and frequency of investor reports.[183] A typical fee charged to a hedge fund manager is 18 basis points per annum, on assets under management.[184] For example, a $100 million fund would pay an annual

179. *See supra* note 45 and accompanying text.

180. *See supra* note 46 and accompanying text.

181. *See* Press Release, Office of Sen. Grassley, *supra* note 2 and accompanying text.

182. *See* Investopedia.com, *supra* note 42; *see also supra* text accompanying notes 42-43; *In re* Kemper Fin. Servs., Inc., Investment Advisers Act Release No. 1387, 51 S.E.C. 715 (Oct. 20, 1993).

183. UBS Global Asset Mgmt., Product Range by Location, http://www.ubs.com/1/e/globalam/fundservices/product_range_location.html#_ams (last visited Oct. 17, 2009).

184. *See* Interview with John C. Liu, *supra* note 15 (Fees charged to hedge funds for fund administration range from 11 to 18 bps per annum calculated on assets under

fee of $180,000. The envisioned added responsibilities of the administrator, however, would most likely cause them to increase their fees. This could lead to strenuous objections from hedge fund lobbyists to any proposed custodian legislation.

In fact, there are several reasons why mandating third party administrators would benefit hedge fund managers. The manager would no longer have to invest in technology and hire personnel to perform back-office and accounting services (as these functions would be dealt with by the fund administrator). Outsourcing functions could therefore be a source of net savings for the manager. Moreover, since the hedge fund manager's primary role is to effectively execute the fund's trading strategy to generate optimal returns, outsourcing these administrative functions would allow managers to focus on their core job: trading assets.

Typically, administrative services are charged to investors as a fund expense.[185] In the post-Madoff environment, a rational investor should have no problems paying added expenses to ensure that their investment is secure from most frauds. In addition, having a third party administrator is likely to boost investor confidence in hedge funds, potentially increasing cash inflows.[186]

V. CONCLUSION

Disclosure is the foundation of the federal securities laws in the United States.[187] Yet despite rigorous disclosure requirements[188] investors have been exposed to significant corporate fraud in the last decade.[189] Recognizing the limitations of disclosure, the Sarbanes-Oxley Act ("SOX") was signed into law in 2002. The Act mandated a number of reforms and created the Public Company Accounting Oversight Board ("PCAOB") to oversee the activities of the auditing

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management. Typically fees decrease as the amount of assets under management increases. In addition, startup funds typically get big breaks on fees.).

185. Ivy Schmerken, *What Is a Fund Administrator?*, ADVANCED TRADING, Jan. 29, 2009, http://www.advancedtrading.com/regulations/showArticle.jhtml?articleID=212903181.

186. *Id.* (After getting caught up in the Madoff scandal and losing millions of dollars, institutional investors are putting pressure on hedge funds to hire third-party fund administrators.).

187. *See* SEC, Laws That Govern the Security Industry, *supra* note 132.

188. *See supra* notes 133-34 and accompanying text.

189. *See supra* notes 158-63 and accompanying text.

profession.

Dishonest managers who have perpetrated some of the outrageous frauds listed in this article would hardly have been deterred simply because they were registered with the SEC. [190] There have been a few examples of registered investment advisers that have perpetrated fraud.[191] In addition, SEC registration might even give investors a false sense of security, thus helping managers who want to commit fraud.

A custody arrangement with an independent third party can prevent many of the frauds discussed in this article. If fighting fraud is the intent of our legislators then a better solution would be the custody of hedge fund assets with an independent third party.

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190. *See* Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2876 (May 14, 2009) (The SEC recognizes the limitations of disclosure. On May 14, 2009, the SEC released a set of proposed rules that includes: adviser to obtain an SAS-70 report from a PCAOB registered and inspected accountant if he holds custody of assets, surprise asset verification exams by an independent public accountant, notification by the accountant of termination of its engagement to the Commission and direct delivery of custodial statements to advisory clients.).

191. *See supra* notes 154-56 and accompanying text.