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As expected, hedge funds remained a predominant focus for the SEC's Enforcement program in 2010. The various insider trading actions arising out of the *Galleon Management, LP* scandal and the focus on expert networks captured most of the year's headlines. Private fund managers, however, should not let the spotlight on insider trading distract them from the SEC's other enforcement priorities. As the cases summarized below demonstrate, the SEC's Division of Enforcement, which includes its fully operational Asset Management Unit, continues to bring cases involving asset valuation and disclosures, PIPE (Private Investment in Public Equities) offerings, cross-trading, and related party transactions, among other areas. With the looming effective date of the registration requirements contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act,[1] 2011 promises to be another year in which private funds will attract substantial attention from the SEC's examinations and enforcement staffs.

Specialized Enforcement Units

At the beginning of 2010, the SEC's Division of Enforcement announced the creation of five specialized units designed to focus on complex subject areas of particular interest to the SEC. One of those specialized units, Asset Management, is dedicated to enforcement matters relating to registered and unregistered investment advisers, including advisers to private funds.[2] The division also created a new Office of Market Intelligence, led by Thomas A. Sporkin, that is responsible for "the collection, analysis, risk-weighing, triage, referral, and monitoring of the extraordinary number of tips, complaints, and referrals the SEC receives each year."[3]

The Asset Management Unit is led by Co-Chiefs Bruce Karpati and Robert B. Kaplan, two associate directors within the Division of Enforcement, and has been fully staffed since the spring of 2010. It consists of approximately a dozen assistant directors in the SEC's home office in Washington, D.C. and nine other regional offices, and individual staff attorneys in each of those locations. The members of the unit reportedly hold regular meetings to share market intelligence, develop investigative leads, and discuss particular theories of liability.

Although the jury is still out on the effectiveness of this new structure, the theory behind the new units—that Division of Enforcement attorneys dedicated to particular areas will be more effective in combating violations of the federal securities laws—is a sound one. As the attorneys in these units become more familiar with the private fund industry, advisers who find themselves subject to SEC scrutiny should expect investigations to proceed more expediently and with greater focus.

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law July 21, 2010 (Pub. L. 111-203, H.R. 4173) (111th Cong. 2010).

2. Press Release, Securities and Exchanges Commission, *SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence* (Jan. 13, 2010).

3. *See* Robert Khuzami, Director, SEC Enforcement Division, "Remarks at News Conference Announcing Enforcement Cooperation Initiative and New Senior Leaders," Jan. 13, 2010.

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Insider trading remained a prominent feature of the SEC's enforcement program in 2010, and hedge funds played a starring role. The cases discussed below include the well-known *Galleon* matter, actions involving expert networks, and a case that demonstrates the importance of establishing procedures reasonably designed to prevent trading on material, nonpublic information.

Galleon and the Focus on Expert Networks

The SEC's most visible actions involving private funds in 2010 involved **Galleon Management LP** (Galleon) and its progeny. In January 2010, the SEC filed a Second Amended Complaint in the case, *SEC v. Galleon Management, LP, et al.*, 09-CV-8811 (S.D.N.Y.) (JSR). The Complaint contained newly alleged claims of insider trading by two of the Galleon hedge fund defendants, **Raj Rajaratnam** (Rajaratnam) and **Anil Kumar** (Kumar), and brought the total amount of insider trading profits (or losses avoided) in the *Galleon* matter above $52 million.[4]

The SEC's initial *Galleon* Complaint, filed October 16, 2009, had alleged that two hedge funds and six individuals, including Rajaratnam and Kumar, had engaged in widespread and repeated insider trading in a variety of securities. The amended Complaint realleged that Kumar, while working as a consultant for global consulting firm McKinsey & Co., acquired nonpublic information regarding eight different companies and sold that information to Rajaratnam, who then used the information to trade on behalf of Galleon. Between 2003 and 2009, Rajaratnam allegedly paid Kumar $1.75 million to $2 million for the inside information, and Kumar invested some of those funds in a nominee account at Galleon, earning an additional $2.6 million in trading profits for his participation in the scheme. The SEC brought these cases simultaneously with criminal indictments issued by the U.S. Attorney's Office for the Southern District of New York (USAO).

By the end of 2010, the SEC and the USAO had expanded the *Galleon* case to include actions against dozens of individuals, including portfolio managers, a registered broker-dealer, and tippers at public companies and consulting firms. A number of these individuals have also entered into consent judgments with the SEC and guilty pleas with the USAO. For example, the SEC entered into Consent Orders and Judgments against Galleon defendants **Roomy Khan** (Khan) and **Rajiv Goel** (Goel) on October 27, 2010 and November 5, 2010, respectively.[5] Goel, who was named in the SEC's original Complaint, was a managing director in the treasury group at Intel Corp. (Intel). Khan, who was named in the First Amended Complaint, was an individual investor who had been employed at Intel in the late 1990s and subsequently worked at Galleon. The SEC alleged that both Goel and Khan unlawfully acquired material nonpublic information and passed it on to Rajaratnam, who traded on the tips.

The SEC entered into similar settlements with the following Galleon defendants in 2010:

- Defendant Kumar (disgorgement and prejudgment interest totaling $2,790,621);
- Defendant **Schottenfeld Group, LLC**, a New York limited liability company and registered broker-dealer (disgorgement of $460,475.28, prejudgment interest of $72,202.72, and a civil monetary penalty of $230,237.64);

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4. *See SEC v. Galleon Mgmt., LP, et al.*, Civil Action No. 09-CV-8811 (S.D.N.Y) (JSR), Litig. Release No. 21397, 2010 WL 332016 (Jan. 29, 2010).

5. *See SEC v. Galleon Mgmt., LP, et al.*, Civil Action No. 09-CV-8811 (S.D.N.Y.) (JSR), Litig. Release No. 21732, 2010 WL 4467012 (Nov. 8, 2010).

- Defendants **Ali T. Far** and **Choo-Beng Lee**, who were managing members of **Far & Lee LLC** (Far & Lee), a Delaware company, and officers of **Spherix Capital LLC** (Spherix), an unregistered hedge fund investment adviser based in San Jose, California (jointly and severally required to pay disgorgement of $1,335,618.17, prejudgment of $96,385.52, and a civil monetary penalty of $667,809.09); and

- Defendants Far & Lee and Spherix (the SEC dropped its claims against these now-defunct entities in exchange for their agreements to cooperate in the SEC's ongoing Galleon investigation and to cease doing investment advisory business).

The SEC also filed a civil injunctive action against **Thomas C. Hardin** (Hardin), a former managing director at a New York–based hedge fund investment adviser, **Lanexa Management LLC** (Lanexa), alleging insider trading in connection with two corporate takeovers and a quarterly earnings announcement.[6] The SEC's Complaint charges Hardin with trading in Hilton, Google, and Kronos securities based on material nonpublic information that Hardin allegedly received from Galleon employee Khan, who, in turn, had received the inside information from three sources: a Moody's rating agency analyst, an employee at Market Street Partners, and an individual at Hellman & Friedman. Hardin, in turn, traded on the tips on behalf of Lanexa and also passed the inside information on to others, who similarly traded on the information. Hardin is charged with violating the antifraud provisions of the securities laws, including Section 17(a) of the Securities Act of 1933 (Securities Act), and Section 10(b) of the Securities Exchange Act of 1934 (Securities Exchange Act) and Rule 10b-5 promulgated thereunder.

Expert networks played a prominent role in many of the insider trading cases brought by the SEC and the USAO. At the beginning of 2011, for example, the SEC filed a civil complaint against six named individuals who were already facing criminal charges for their purported involvement in an insider trading scheme at an expert networking firm, **Primary Global Research LLC** (PGR).[7] Two of the individuals (**Bob Nguyen** and **James Fleishman**) were employees of PGR; the other four (**Mark Anthony Longoria**, **Daniel L. DeVore**, **Winifred Jiau**, and **Walter Shimoon**) were technology company employees who acted as consultants for PGR. Together, they allegedly passed along confidential information regarding quarterly earnings and performance data to hedge funds and other PGR clients who pocketed nearly $6 million in trading gains as a result of the unlawful tips. All six individuals have been arrested and charged on related fraud and conspiracy charges: Nguyen and Devore have pleaded guilty and are cooperating in the SEC's investigation.

The SEC brought another insider trading case involving consultants on November 2, 2010,[8] this one against **Yves M. Benhamou, M.D**. (Benhamou), a French doctor and consultant who is charged with unlawfully providing an unnamed hedge fund portfolio manager with material, nonpublic information regarding a clinical trial by **Human Genome Science, Inc**. (HGSI) for the drug Albumin Interferon Alfa 2-a (Albuferon), a potential drug to treat hepatitis-C, in advance of HGSI's January 23, 2008 negative press announcement regarding the trials.

The SEC's Complaint, filed in the Southern District of New York, alleges that Benhamou, who served on the Steering Committee overseeing HGSI's clinical trial of Albuferon, tipped the unidentified hedge fund manager about problems HGSI encountered during

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6. *See SEC v. Thomas C. Hardin*, Civil Action No. 10-CV-8600 (S.D.N.Y.), Litig. Release No. 21740, 2010 WL 4600197 (Nov. 15, 2010).

7. *See SEC v. Mark Anthony Longoria, et al.*, Civil Action No. 11-CV-0753 (S.D.N.Y.), Litig. Release No. 21836 (Feb. 3, 2011).

8. *See SEC v. Dr. Yves M. Benhamou,* Civil Action No. 10-CV-8266 (S.D.N.Y.), Litig. Release No. 21721, 2010 WL 4325241 (Nov. 2, 2010).

Phase 3 of the trial (Benhamou had previously provided consulting services to the portfolio manager). Benhamou's tips were made to the manager in stages, as the clinical trial progressed. According to the Complaint, the portfolio manager knew or should have known that Benhamou was affiliated with the trial and breached his duty of confidentiality to HGSI when he tipped the portfolio manager material, nonpublic information about the trial studies. Nevertheless, acting on the material, nonpublic information provided by Benhamou, the hedge fund manager sold his entire position in HGSI stock (approximately six million shares held by six healthcare-related hedge funds that he co-managed, including a block trade of two million shares just before the markets closed the day before HGSI's negative press announcement). By doing so, the fund manager avoided $30 million in losses (the shares lost 44% of their value after the press release). The SEC charged Benhamou with violating the antifraud provisions of the federal securities laws, Section 17(a) of the Securities Act, and Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. The Complaint seeks a final judgment permanently enjoining Benhamou from future violations of the federal securities laws, and ordering payment of disgorgement, prejudgment interest, and financial penalties. The USAO has filed a parallel criminal action against Benhamou based on the same underlying misconduct; the SEC's investigation of the hedge fund manager is ongoing.

Policies and Procedures Regarding Material, Nonpublic Information

Another recent case that touched on insider trading issues involved **The Buckingham Research Group, Inc**. (BRG) (a registered broker-dealer and institutional equity research firm), its subsidiary **Buckingham Capital Management, Inc.** (BCM) (a registered investment advisor), and **Lloyd R. Karp** (Karp) (the chief compliance officer for both entities).[9] The SEC issued an Order on November 17, 2010 against BRG, BCM, and Karp, imposing fines and a cease and desist order—not for insider trading, but for failing to have policies and procedures in place to detect and prevent insider trading. In its order, the SEC alleged that BRG and BCM failed to have adequate policies and procedures in place to protect material, nonpublic information, and that the defendants failed to enforce the limited policies that they did have in place. For example, BRG had a policy that required its research analysts to complete a certification form, stating that the analysts had maintained the confidentiality of the material research information, any time there was a significant change in BRG's research recommendations (such as the initiation of research coverage on a company, or a revision to a price target). The policy was designed to address the information flow risk between BRG and BCM, but it was not followed.

Several other factors further supported the SEC's charges against the defendants, including findings that Karp caused the violations because he was "responsible for establishing and administering all compliance policies" within the firms (and was the CCO of both firms which, in itself, was deemed by the SEC to be a conflict), that BCM employed former BRG analysts as portfolio managers, that BCM executed its trades through BRG (and accounted for 25% of BRG's trading revenues), and that BRG and BCM shared office space but were separated only by a "partial glass partition." The SEC also alleged that the respondents fabricated and produced data (including preapproval forms for more than 100 employee trades and incomplete compliance review logs for 2005 and 2006) to the Commission's examination staff without disclosing that the documents had been fabricated or otherwise altered.

The SEC charged BRG with violating Section 15(f) of the Securities Exchange Act and Section 204A of the Investment Advisers Act of 1940 (Advisers Act) (because it controlled BCM), BCM with violations of Section 204A of the Advisers Act and Section 15(f) of the Securities Exchange Act (due to its status as a BRG subsidiary), and Karp

9. *See In the Matter of The Buckingham Research Group, Inc., et al.*, Exchange Act Release No. 63323 (Nov. 17, 2010).

with aiding and abetting BRG and BCM in their violations of the securities laws. Without admitting or denying the findings in the Order, BRG agreed to a penalty of $50,000, BCM agreed to a penalty of $75,000, and Karp agreed to a penalty of $35,000. All of the respondents consented to a censure and agreed to cease and desist from committing or causing any further violations of Section 15(f) of the Securities Exchange Act or Sections 204(a), 204A, and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

Insider Trading in Complex Products

Two years ago, we reported on the SEC's first insider trading case involving credit default swaps (CDSs).[10] In a Complaint filed on May 5, 2009, the SEC alleged that **Renato Negrin** (Negrin), a former portfolio manager at hedge fund **Millennium Partners, L.P**. (Millennium) and **Jon-Paul Rorech** (Rorech), a salesman at **Deutsche Bank Securities Inc**., engaged in insider trading in the CDSs of an international holding company, **VNU N.V** (VNU). The Commission alleged that Rorech learned about a change to an upcoming VNU bond offering that was expected to increase the price of the CDSs on VNU bonds. He allegedly tipped Negrin to the contemplated change, and Negrin subsequently purchased CDSs on VNU for a Millennium hedge fund. After the restructured bond offering was announced, Negrin closed the CDS position, realizing a $1.2 million profit. The SEC charged Rorech and Negrin with violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.

In 2009, the SEC scored a major victory when the court declined to dismiss the case, holding that the trading in CDSs could fall within the federal securities laws. That victory was short lived, however. On June 25, 2010, U.S. District Judge John G. Koeltl ruled that the SEC failed to establish that Rorech and Negrin engaged in insider trading, finding instead that the information shared between the two men regarding the VNU bond offering was not confidential information and that Rorech had no motive to provide inside information to Negrin.[11]

PIPE Offerings

Last year saw the conclusion of a notable case we summarized in previous years involving hedge fund manager **Robert A. Berlacher** (Berlacher). On September 14, 2010, the SEC announced that the Honorable Mitchell S. Goldberg of the U.S. District Court for the Eastern District of Pennsylvania had found Berlacher, along with several of the hedge funds and investment advisory entities he managed, liable for securities fraud in connection with certain of the funds' PIPE investments.[12] The Commission's Complaint, filed on September 13, 2007, alleged that Berlacher, his investment advisory firms (**LIP Advisors, LLC**, **NCP Advisors, LLC**, and **RAB Investment Company, LLC**), and hedge funds they advised (**Lancaster Investment Partners, L.P.**, **Northwood Capital Partners, L.P.**, **Cabernet Partners, L.P.**, **Chardonnay Partners, L.P.**, **Insignia Partners, L.P.**, and **VFT Special Ventures, Ltd**.) made materially false representations to issuers in connection with two unregistered PIPE offerings.

In the first PIPE offering, for **Radyne ComStream, Inc.** (Radyne), the court found that Berlacher's securities purchase agreement for Radyne misrepresented Berlacher's position in Radyne: the reality was that Berlacher, after learning about the Radyne PIPE offering, had established a "barrier option" position on a "basket" of securities (i.e., a

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10. *See SEC v. Rorech*, 720 F. Supp. 2d 367 (S.D.N.Y. 2010).

11. *Id.* at 373.

12. *See SEC v. Robert A. Berlacher, et al.*, Civil Action No. 07-CV-3800 (E.D. Pa.) (MSG), Litig. Release No. 21648, 2010 WL 3588432 (Sept. 14, 2010).

portfolio of underlying assets), one of which included a short position in Radyne securities, providing him with leverage and giving him the right to the underlying assets. Similarly, in the second PIPE offering, for **International Displayworks, Inc.** (IDWK), Berlacher misrepresented in the securities purchase agreement that he had not engaged in any transactions in IDWK's securities when he had, in fact, also established a "barrier option" position that included positions in IDWK as part of its underlying "basket" of securities, again after learning about the IDWK PIPE. As a result of these misrepresentations, the court found that Berlacher violated the antifraud provisions of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. The court ordered the defendants to pay, jointly and severally, $352,363.68 in disgorgement.

Valuation and Disclosures

The SEC continued to scrutinize valuation and disclosure practices in 2010. For example, in October, the SEC charged hedge fund manager **Stephen M. Hicks** (Hicks) and his investment advisory businesses with defrauding investors in funds managed by **Southridge Capital Management LLC** and **Southridge Advisors LLC**.[13] Hicks allegedly defrauded investors in three ways: (1) by overvaluing the funds' largest position through fraudulently misstating the assets' purchase price, thereby wrongfully valuing the portfolio and wrongfully causing the accrual of hundreds of thousands of dollars in management fees every year; (2) by misusing and misappropriating liquid assets in certain funds to pay nearly $5 million in legal and administrative expenses associated with other illiquid funds Hicks managed; and (3) by failing to disclose the misappropriation of fund assets to investors and then eventually replacing those improperly allocated funds with illiquid securities. The SEC's Complaint charges Hicks with violations of Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The Commission seeks injunctive relief, disgorgement of profits, prejudgment interest, and financial penalties.

In another valuation case dated October 19, 2010, the SEC charged hedge fund portfolio managers **Paul T. Mannion, Jr**. (Mannion) and **Andrews S. Reckles** (Reckles), and two advisers they controlled (**PEF Advisors LLC** and **PEF Advisors**) with defrauding investors in **Palisades Master Fund, L.P.** (PMF) by, among other things, overvaluing illiquid fund assets placed in a fund "side pocket" and by misappropriating PMF's assets.[14] More specifically, the SEC's Complaint, filed in the U.S. District Court for the Northern District of Georgia, alleged that Mannion and Reckles placed certain hedge fund assets in a "side pocket" (a type of account used by hedge funds to separate particular—typically illiquid—investments from the remainder of the funds' assets) and valued those investments in a manner that was both inconsistent with the fund's disclosures and contrary to Mannion's and Reckles's undisclosed internal assessment of the investments' value. The fraudulent valuations, in turn, enabled Mannion and Reckles to report misleadingly inflated net asset values to investors, thereby allowing the defendants to receive excessive management fees from the fund. The Commission also charged Mannion, Reckles, and their investment adviser entities with making material misrepresentations in connection with a private stock offering, stealing warrants belonging to the fund that were worth $1.6 million when subsequently exercised, and improperly using investors' cash to pay for their own personal investments when, without disclosure, they misappropriated $2 million from the fund—apparently as a short-term

13. *See SEC v. Southridge Capital Mgmt. LLC, et al.*, Civil Action No. 3:10-CV-1685, Litig. Release No. 21709, 2010 WL 4195996 (Oct. 25, 2010).

14. *See SEC v. Paul T. Mannion, Jr., et al.*, Civil Action No. 10-CV-3374 (N.D. Ga.), Litig. Release No. 21699, 2010 WL 4112845 (Oct. 19, 2010).

loan—to finance their personal investments. They misappropriated another $13,000 from the fund to pay for services not rendered to the fund and to purchase additional warrants for their personal accounts. Lastly, Mannion and Reckles made material misrepresentations in connection with the Radyne ComStream Inc. PIPE offering (discussed above).

The SEC's Complaint charges the defendants with violations of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder and Sections 206(1) and 206(2) of the Advisers Act. The Complaint seeks injunctive relief, disgorgement of profits, prejudgment interest, and civil monetary penalties. Additionally, the Complaint seeks disgorgement from the fund as a relief for profits the defendants obtained through the illegal trading in Radyne securities.

Related Party Transactions

In several recent cases, the SEC has taken action against hedge fund managers for engaging in related party transactions. Although the SEC's theories and charges in these two cases are somewhat inconsistent, thereby blurring the message they send, private fund advisers must be wary of the potential conflicts that arise in related party transactions, the rules that may be implicated by such transactions, and the disclosure obligations that may apply.

Principal Trading Issues

At the end of 2010, the SEC issued an administrative order, on consent, against two investment advisers—**American Pegasus LDG, LLC** (APLDG) and **American Pegasus Investment Management, Inc.** (APIM)—and the firms' former CEO **Benjamin P. Chui** (Chui), former general counsel **Charles E. Hall, Jr.**, and former portfolio manager **Triffany Mok**. The order found that the respondents collectively engaged in fraudulent conduct, including failing to disclose conflicts of interests, misusing client assets, and engaging in improper self-dealing.[15] For example, the investment advisers managed assets held by several offshore hedge funds that invested in subprime auto loans while the three former officers (the Officers) simultaneously owned a holding company that acquired a finance company that was the sole supplier of subprime auto loans to the largest of the hedge funds (the Auto Fund). The holding company financed the acquisition using more than $18 million in undisclosed loans and advances from the Auto Fund, creating an inherent conflict of interest that the Officers and firms failed to disclose to their hedge fund clients. Chui also allegedly pulled millions of dollars from the Auto Fund to prop up other hedge funds he managed. By late 2008, roughly 40% of the Auto Fund's "assets" consisted of loans made to or on behalf of related parties, and fund investors were paying management fees based on the value of those undisclosed related party payments. Finally, to cover their initial misconduct, the Officers then wiped the debt off of the firms' books by selling assets to the Auto Fund at a significant mark-up (for example, in February 2009, they purchased an auto loan portfolio for $12 million and later that day sold the exact same portfolio to the Auto Fund for $38 million).

The SEC's Order found that the Respondents willfully violated Section 17(a) of the Securities Act, Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), 206(3) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. The Officers were found liable for aiding and abetting the firms' fraudulent misconduct and were barred from associating with an investment adviser.

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15. *See In the Matter of American Pegasus LDG, LLC, et al.*, Exchange Act Release No. 34-63585, 2010 WL 5176821 (Dec. 21, 2010).

Although the fraud and disclosure charges involving APLDG and APIM were not particularly novel, what is interesting about the case is the charge under Section 206(3) of the Advisers Act, which requires advisers to make disclosure of, and obtain consent for, principal transactions in securities. The SEC charged APLDG and APIM with failing to make such disclosures and obtain consents for transactions involving the purchase of nonsecuritized subprime auto loans from an affiliate. The SEC's Order contains no analysis of why such loans would be considered securities, thereby implicating Section 206(3).

Just a month later, in January 2011, the SEC filed charges against another hedge fund manager, **Francisco Illarramendi**, based on charges that the adviser made undisclosed loans to affiliated companies, which in turn used the borrowed funds to invest in private equity-type investments. The SEC charged the adviser with fraud under the Advisers Act, but not under Section 10(b) of the Securities Exchange Act or Section 17(a) of the Securities Act. Nevertheless, the SEC is seeking extraordinary relief in the case, including an asset freeze and the appointment of a receiver. In its complaint, the SEC alleges that the fund's private placement memoranda (PPM) did not provide for the possibility that the fund would make loans to affiliates, that the loans to affiliates were unsecured and not documented, and that the loans were not disclosed to clients.

Although the Illarramendi case involved loans to related parties that were purportedly not disclosed to the adviser's clients or approved by them, the SEC did not charge a violation of Section 206(3) of the Advisers Act. Based on the pleadings, it is not possible to distinguish the loans in the Illarramendi case from the loans in *American Pegasus*, at least with respect to the possible application of the principal trade disclosure and consent requirements of Section 206(3). Advisers will want to watch closely developments in the Illarramendi case, which is not settled, and for any similar cases, to get a clearer view of the SEC's stance on the applicability of Section 206(3) to loans and other products that are not clearly securities.[16]

Other Related Party Transaction Cases

On February 3, 2010, after granting the SEC's motion for summary judgment, the Honorable Orinda D. Evans, U.S. District Judge for the Northern District of Georgia, entered an Order against defendants **James A. Jeffery** (Jeffery) and **Thomas E. Repke** (Repke), finding that they engaged in unlawful related party transactions, including making over $3 million in loans from investors' money to themselves without obtaining prior investor approval or disclosing the loans to investors. Additionally, Jeffery and Repke falsely represented anticipated rates of return (claiming monthly returns of 3%-6%), misrepresented that principal was protected and never left the funds' escrow accounts, and falsified monthly account statements to disguise the fact that approximately $5 million in fund assets had been fraudulently disbursed to related parties. The court ordered that they pay disgorgement in the amounts of $1,228,739.29 and $2,739,862.33, respectively, along with prejudgment interest and civil monetary penalties equal to their respective disgorgement amounts.[17] Jeffery and Repke (along with co-defendants **Coadum Advisors, Inc.** (Coadum), **Mansell Capital Partners III, LLC** (Mansell), **Coadum Capital Fund I, LLC**, **Coadum Capital Fund II, LP**, **Coadum Capital Fund III, LP** and **Mansell Acquisition Company LP**) had previously been permanently enjoined from violating Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. The court had also previously

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16. On March 7, 2011, the SEC amended its complaint against Illarramendi and his firm, Michael Kenwood Capital Management LLC, to add charges that they engaged in a long-running Ponzi scheme. The same day, Illarramendi pled guilty to related fraud charges in U.S. District Court in Connecticut.

17. *See SEC v. Coadum Advisors, Inc., et al.*, Civil Action No. 1:08-CV-0011-ODE (N.D. Ga.), Litig. Release No. 21406, 2010 WL 379415 (Feb. 3, 2010).

enjoined defendants Coadum, Mansell, Jeffery, and Repke from future violations of Sections 206(1) and 206(2) of the Advisers Act.

On September 7, 2010, the SEC brought charges against **Neal R. Greenberg** (Greenberg), alleging fraud and breach of fiduciary duty by Greenberg in his roles as CEO of **Tactical Allocation Services**, a registered investment adviser, and head portfolio manager for **Agile Group, LLC** (Agile Group), another investment adviser.[18] The SEC alleged that Greenberg, in connection with the recommendation and sale of funds managed by Agile Group (sales were often made to elderly investors), made material misrepresentations and omissions, including misrepresentations that materially overstated the diversification and liquidity of the funds, thereby also materially understating the risks of investing in the funds. Further, several of the funds were both highly leveraged and heavily concentrated in a small number of investments, ultimately resulting in Agile Group's decision to cease redemptions in the funds, many of which ultimately collapsed in late 2008.

Of particular note in the *Greenberg* case is that the PPM for several of the funds stated that no additional fees would be charged where investor capital was allocated to affiliated funds. However, the funds did, in fact, charge management and performance fees on the leveraged portion of the funds (i.e., when one of the Agile Group hedge funds invested in another Agile Group hedge fund). The fees on the leveraged portion of the funds—amounting to approximately $2 million—were not properly disclosed to investors. In its Order, the SEC alleged that the PPM failed to adequately disclose the additional management and performance fees that would be charged on leverage, that significant layering of fees could occur, and that conflicts of interest could arise when one of the Agile Group funds invested in another fund.

Cross-Trading and Other Conflicts of Interest

Although not directly involving a hedge fund, the SEC's case against a collateralized debt obligation (CDO) manager for improper cross-trades is noteworthy. On June 21, 2010, the SEC filed a civil action in the U.S. District Court for the Southern District of New York against investment advisory firm **ICP Asset Management, LLC** (ICP) its founder, owner, and president, **Thomas Priore** (Priore); its affiliated broker-dealer, **ICP Securities, LLC**; and its holding company, **Institutional Credit Partners, LLC**, charging the defendants with cross-trading and fraudulently managing four multibillion-dollar portfolios of CDOs, known as the "Triaxx CDOs."[19] The CDOs invested primarily in mortgage-backed securities. According to the Complaint, ICP engaged in several types of prohibited and fraudulent conduct, including self-dealing, engaging in fraudulent transactions between the CDOs (cross-trading), making trades that benefited other ICP clients at the expense of Triaxx, trading to benefit one CDO at another CDO's expense, and breaching its fiduciary duties to the CDOs generally. ICP's misrepresentations and fraudulent conduct allegedly caused Triaxx to lose tens of millions of dollars. At the same time, Priore wrongfully obtained tens of millions of dollars in advisory fees and undisclosed profits at the expense of ICP's clients and investors. The defendants also allegedly directed more than a billion dollars of trades for the CDOs at inflated prices (sometimes exceeding market prices by substantial margins) to make money for ICP and to protect other ICP clients from realizing losses.

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18. *See In the Matter of Neal R. Greenberg*, Exchange Act Release No. 34-62855, 2010 WL 3492149 (Sept. 7, 2010).

19. *See SEC v. ICP Asset Mgmt., LLC, et al.*, Civil Action No. 10-CV-4791 (S.D.N.Y.), Litig. Release No. 21563, 2010 WL 2510711 (June 21, 2010).

According to the SEC's Complaint, which seeks a final judgment permanently enjoining the defendants from future violations of the federal securities laws and ordering them to pay disgorgement, prejudgment interest, and civil monetary penalties, ICP and Priore caused the CDOs to make numerous prohibited investments without obtaining necessary approvals and later misrepresented those investments to both the Triaxx trustee and its investors. The Complaint alleges violations of Section 17(a) of the Securities Act, Sections 10(b) and 15(c)(1)(A) of the Securities Exchange Act and Rule 10b-5 thereunder, and Sections 204 and 206(1), (2), (3) and (4) of the Advisers Act and Rules 204-2, 206(4)-7, and 206(4)-8 thereunder. Finally, the Complaint alleges violations by Priore of Section 10(b) and Section 15(c)(1)(A) of the Securities Exchange Act and Rules 10b-3 and 10b-5 thereunder as a control person.

If you have any questions regarding the issues discussed above, please contact any of the following Morgan Lewis attorneys:[20]

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20. Anne Flannery and Ivan Harris are partners, and Andrew Southerling is an associate, in the Securities Enforcement and Litigation Practice of Morgan Lewis. Wendy Hart, an associate at the firm, also contributed to this article.