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SEC Charges Multiple Hedge Fund Managers with Fraud in Inquiry Targeting Suspicious Investment Returns

BY THE INVESTMENT MANAGEMENT PRACTICE

On December 1, 2011, the U.S. Securities and Exchange Commission (the "SEC") announced that it has brought enforcement actions against three advisory firms and six individuals for various types of misconduct including improper use of fund assets, fraudulent valuations, and misrepresenting fund returns.[1] Notably, the SEC stated that these actions were "part of an initiative to combat hedge fund fraud by identifying abnormal investment performance." Earlier this year, during congressional testimony, Robert Khuzami, the Director of the SEC's Division of Enforcement (the "Enforcement Division"), faced questions regarding the SEC's response to the Madoff scandal.[2] During his testimony, Khuzami announced an investigative and enforcement initiative targeting hedge funds and their managers. He reported that the Enforcement Division is now focusing on hedge funds that outperform "market indexes by 3% and [are] doing it on a steady basis." Khuzami referred to such performance as "aberrational," and stated that the Enforcement Division is "canvassing all hedge funds" for such "aberrational performance."

The new enforcement actions are part of the SEC's Aberrational Performance Inquiry initiative, pursuant to which the Enforcement Division's Asset Management Unit is using "proprietary risk analytics to evaluate hedge fund returns. Performance that appears inconsistent with a fund's investment strategy or other benchmarks forms a basis for further scrutiny." According to Khuzami, the SEC staff is "using risk analytics and unconventional methods to help achieve the holy grail of securities law enforcement — earlier detection and prevention. This approach, especially in the absence of a tip or complaint, minimizes both the number of victims and the amount of loss while increasing the chance of recovering funds and charging the perpetrators."

Robert Kaplan and Bruce Karpati, Co-Chiefs of the Enforcement Division's Asset Management Unit, stated that the SEC staff is "applying analytics across the investment adviser space — beyond performance and beyond hedge funds." They added that the advisers and portfolio managers involved in these actions were reporting extraordinary, "outlier" returns that were "in most cases, too good to be true" or a sign that "something else was amiss." Specifically, the SEC has alleged that the firms and managers involved in these actions engaged in a wide variety of illegal practices in the management of hedge funds or private pooled investment vehicles, including fraudulent valuation of portfolio holdings, misuse of fund assets, and misrepresentations to investors about critical attributes

such as performance, assets, liquidity, investment strategy, valuation procedures, and conflicts of interest.

The SEC has filed a number of enforcement actions to date stemming from this initiative. Of the four actions announced on December 1, 2011, three were filed in federal court and one was brought as an administrative proceeding.

Michael Balboa and Gilles De Charsonville

The SEC charged Michael Balboa, former portfolio manager of the Millennium Global Emerging Credit Fund, and Gilles De Charsonville of BCP Securities LLC for engaging in a fraudulent scheme to inflate the fund's reported monthly returns and net asset value by manipulating the supposedly independent valuation process.

ThinkStrategy Capital Management and Chetan Kapur

The SEC charged the New York-based hedge fund firm ThinkStrategy Capital Management LLC and its sole managing director Chetan Kapur with engaging in a pattern of deceptive conduct designed to bolster the firm's track record, size, and credentials. According to the SEC, ThinkStrategy and Kapur repeatedly inflated the firm's assets, exaggerated the firm's longevity and performance history, and misrepresented the size and credentials of the firm's management team.

Patrick Rooney and Solaris Management

The SEC charged Patrick G. Rooney and his company Solaris Management LLC for fraudulently misusing the assets of the Solaris Opportunity Fund LP, to which it was the investment adviser. The complaint alleges that Rooney and Solaris made a radical change in the fund's investment strategy, contrary to the fund's offering documents and marketing materials, by becoming wholly invested in Positron Corp., a financially troubled microcap company.

LeadDog Capital Markets, Chris Messalas and Joseph LaRocco

The SEC instituted administrative proceedings against an unregistered investment adviser LeadDog Capital Markets LLC and its general partners and owners Chris Messalas and Joseph LaRocco for misrepresenting or failing to disclose material information to investors in the LeadDog Capital LP fund. The SEC alleges that LeadDog, Messalas and LaRocco induced investors to invest in a hedge fund they controlled through material misrepresentations and omissions concerning, among other things, Messalas's negative regulatory history as a securities professional, compensation received by Messalas and LaRocco in connection with the fund's investments, and Messalas's substantial ownership interest in, and control of, some of the same companies to which he directed fund investments.

These new enforcement actions are evidence that the SEC and its staff are devoting significant resources and creativity to identifying and prosecuting fraud in the private fund space, and we anticipate that additional proceedings in this area will arise in 2012.[3]

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[1] "SEC Charges Multiple Hedge Fund Managers with Fraud in Inquiry Targeting Suspicious Investment Returns"; See http://www.sec.gov/news/press/2011/2011-252.htm for a copy of the SEC's Press Release.

[2] Oversight of the U.S. Securities and Exchange Commission's Operations, Activities, Challenges and FY2012 Budget Request Hearing before the H. Comm. on Fin. Servs., 112th Cong. 1 (March 10, 2011) (Testimony of Robert Khuzami, Director of the SEC's Division of Enforcement).

[3] See our previous alert, "Hedge Fund Report - Summary of Key Developments - Fall 2011" at n.1., available here: http://www.paulhastings.com/assets/publications/2039.pdf?wt.mc_ID=2039.pdf.

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