Testimony of

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TESTIMONY OF
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UNITED STATES SENATE COMMITTEE ON THE JUDICIARY

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224 Dirksen Senate Office Building
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Mr. Chairman, Senator Leahy, Committee Members:
The subject of your Committee's hearing today (Hedge Funds and Independent Analysts: How Independent Are Their Relationships?) is the most recent variant of a stubborn question that keeps popping at Senate committee hearings: is federal law enforcement adequately protecting the nation's capital markets and their participants from the risk of manipulation and fraud by the nation's 11,500 hedge funds? The answer is no.

And the answer is no whatever facts you consider. It is no when the Securities and Exchange Commission ("SEC") fails to recognize any hedge fund fraud or manipulation against other market participants for a quarter century: from 1979 until 2004. It is no when the SEC fails to protect mutual fund investors when billions of dollars are siphoned from their accounts by hedge funds. It is no when you compare what the SEC is doing and saying about hedge funds with what its counterparts in Europe are doing and saying. It is no when the Department of Justice ("DOJ") merely shadows the SEC's meager scrutiny of hedge funds. It is a deafening no when senior SEC officials throw a roadblock in the insider trading investigation of one of the nation's largest hedge funds because the suspected tipper has powerful political connections, as they did with the investigation assigned to me.

Overview

From September 2004 through September 2005, I had primary responsibility for conducting an investigation by the Securities and Exchange Commission ("SEC") of suspected insider trading and market manipulation by one of the nation's largest hedge funds, Pequot Capital Management ("PCM"). I worked long hours on the investigation with other equally committed staff. Among them was a thirty-year SEC veteran, then SEC's most experienced and respected investigator of insider trading. His duties included teaching incoming Enforcement attorneys and foreign regulators how to conduct an insider trading investigation. At his retirement party, he told Enforcement Director, Linda Thomsen, in my presence that the PCM investigation was the most important one he had worked on in his thirty-year career with the SEC. Another seventeen-year veteran, who worked side by side with me, told me the same. His expertise was market manipulation and insider trading.

I believe the nation's capital markets face a growing risk from unregulated pools of money--now called hedge funds--just as they did in the 1920s from unregulated pools of money--then called syndicates, trusts or pools. Those unregulated pools were instrumental in delivering the 1929 Crash. They were, among other things, skilled at using various devices to manipulate stock prices to trick the public. There is growing evidence that today's unregulated pools--hedge funds--have advanced and refined the practice of manipulating and cheating other market participants.

One final introductory point: you may be curious why someone comes to the SEC after twenty-eight years as a trial attorney in private practice. I left the full-time practice of law in 1995. I had achieved my professional and economic goals and had no intention of returning to the full-time practice. Five years later, I looked back on that career that had missing chapter. Very little of it had been devoted to public service. I decided it was not too late to write that chapter and returned to law school to retool for that purpose. While at Georgetown, I decided my skills might be useful at the SEC.

The "Good Old Times" Are Back Again

Fixing the SEC so it can protect investors and capital markets from hedge fund abuse will not be an easy task. Powerful interests want the SEC to stay just the way it is or, better yet, to become even weaker. Those interests are not just the hedge funds. They include the financial industries that are receiving tens of billions of dollars in revenues for helping hedge funds cheat other market participants or close their eyes to the carnage. At the top of that list are the big investment banks, e.g., Goldman Sachs, Morgan Stanley, Merrill Lynch and Bear Stearns. Those interests know how to reward friends and punish perceived enemies. Their tentacles reach far. They stopped the hedge fund investigation I was assigned to conduct. They cost me my job.

Wall Street's misuse of influence is nothing new. Ferdinand Pecora sensed this misuse of influence when he conducted the investigation in 1933 and 1934 on behalf of the Senate Banking Committee that led to the adoption of the securities acts and the creation of the SEC. His detailed cross-examination of powerful bankers, brokers, and industrialists revealed the ills the securities acts were designed to cure.

Five years later, he warned in Wall Street under Oath:

Under the surface of the governmental regulation of the securities market, the same forces that produced the riotous speculative excesses of the "wild bull market" of 1929 still give evidences of their existence and influence. Though repressed for the present, it cannot be doubted that, given a suitable opportunity, they would spring back into pernicious activity (emphasis added).

Frequently we are told that this regulation has been throttling the country's prosperity. Bitterly hostile was Wall Street to the enactment of the regulatory legislation. It now looks forward to the day when it shall, as it hopes, reassume the reigns of its former power. . . .

The public, however, is sometimes forgetful. As its memory of the unhappy market collapse of 1929 becomes blurred, it may lend at least one ear to the persuasive voices of The Street subtly pleading for a return to the "good old times."

I suggest the "good old times" are now back again and the device Congress designed to protect the public investor--the SEC--needs fixing.

The first step in getting a handle on the risks posed by hedge funds is to separate and tag them. I believe there are three risks: (1) hedge fund conduct that cheats their own investors; (2) hedge fund conduct that randomly cheats everybody else, and (3) the systemic risks such as those that surfaced when Long Term Capital Management ("LTCM") collapsed. I will not address the LTCM class of risks because it is beyond my expertise and its solution appears to involve multiple federal agencies.

Hedge Fund Fraud Has Two Distinct Classes of Victims

There are two different species of hedge fund fraud. They are easily distinguished because each has a different victim. One species victimizes the hedge fund's own investors--wealthy individuals and institutions. The other species randomly victimizes everybody else.

Hedge Fund Fraud against Hedge Fund Investors

This species of fraud poses little risk of a severe crisis to the capital markets for multiple reasons. First, the incidence of fraud by hedge funds against their own investors is not disproportionately high. Further, when hedge funds do cheat their own investors, the character of fraud is not unique. Put differently, a Ponzi scheme is a Ponzi scheme whether the investment vehicle is a corporation, an investment trust, or a hedge fund. That means the SEC has the experience to tackle this species of fraud. They have been doing it for decades. Indeed, through September 2003, all 38 enforcement actions the SEC brought against hedge funds over the prior four years were exclusively for this class of fraud--hedge funds victimizing their own investors.

Further, hedge fund investors, as a class, are not the easiest targets. They are wealthy individuals and institutions. They are more likely to become suspicious when the quarterly reports are a bit off. If they don't get the right answers, they are prone to call their attorneys, who file lawsuits and call the SEC. Once again, the SEC knows how to investigate this kind of fraud.

Of course, wealthy individuals and institutions have entrusted $1.2 trillion to hedge funds. That is a big chunk of money, but it is only a tiny fraction of the total assets that individuals and institutions have invested in the capital markets. For example, mutual funds collectively manage $9.2 trillion. The bond and equity markets are more than $40 trillion. Globally, $90 trillion of financial assets are under management. Thus, by any measure, hedge funds have significant assets, but by no means dominate the capital markets. No amount of fraud by hedge funds against their own investors could cripple the capital markets. It is too little money.

From these facts, the hedge fund industry and others contend that hedge funds need no special attention. Why shackle an industry that does so much good for our capital markets, e.g., liquidity or risk transfer? Though the comments are valid when applied to the first species of hedge fund fraud, they are off the mark when applied to the second species discussed next.

Hedge Fund Fraud against Other Market Participants

This species of fraud has an easier target and a far greater potential to disrupt the capital markets. Its victims have no connection with the hedge fund. They are random victims. Much like the victims of a sniper, they never knew what hit them. For example, the millions of mutual fund investors had no clue that billions of dollars were being siphoned from their investment accounts each year by hundreds of hedge funds, as it happened in the recent mutual fund scandal. Likewise, the value investor has no clue that an attractively priced small cap is on its way to bankruptcy via the naked shorting of an $8 billion hedge fund. Similarly, the most sophisticated institutional investor will not second guess the expensive computer model when it begins blinking sell on XYZ stock because it has become overpriced. How could that investor know several hedge funds are buying up XYZ stock because they have been tipped by an investment bank executive that Google will make a tender offer for XYZ at a 50% premium to its current stock price?

The use of invisible fraud and manipulation is nothing new. It was just as invisible in the 1920s when banks and brokers employed the same devices to cheat the public. Pecora described why the public could not detect this type of fraud in the 1920s in words that ring true today:

> The Public was always in the dark. It could not tell whether sales were due merely to the "free play of supply and demand," or whether they were the product of manipulated activities...It all looks alike on the ticker. Nor did the public have access to the inside information on which the officers, the directors and the dominant shareholders act (emphasis added).

In the Darwinian hedge fund world, cheating other market participants has its benefits. It increases the profits to the hedge fund's wealthy individual and institutional investors. Those happy folk tell their friends. New money increases assets under management. The hedge fund takes 2% of those new assets plus 20% of any profits those assets generate. If a manager can maintain that track record, he may join a very exclusive club. The top twenty-five hedge fund managers individually made between $130 million and $1.5 billion last year. The key to getting an investor to plunk down $500,000 to $50 million subject to the 2% and 20% hedge fund take: "As long as the performance is up there, in the end the investors do not care about the high fees."

It also works the other way. A hedge fund manager may find his investors heading for the door. The profits at rival funds are a couple points higher. Rumors circulate that the competition found a way to siphon funds from mutual fund accounts. To survive, a hedge fund must learn to siphon. One after another, hedge funds learn the trick. Fortune Magazine offers this colorful and insightful account how market timing and late trading spread like a virus from one hedge fund to another until it infected more than 400:

Eddie Stern's saga is the untold tale of the market-timing scandal: where the practices were conceived, how they took hold, and how they metastasized from a benign cat-and-mouse game to a sophisticated gambit in which hedge funds slung around billions, compromising an entire industry. "It was like a little brotherhood of people who embraced this niche in life," says Brown, "a whole grotesque industry growing up based on screwing small investors. It's about as bad as it gets."

This species of fraud--victimizing other market participants--also operates under the SEC's radar. In fact, it went undetected by the SEC until September 2003, and, even then, it was not the SEC that discovered it. Rather, a state attorney general announced the first case and settlement involving a hedge fund that had used the market timing and later trading devices to siphon funds from the accounts of unsuspecting mutual fund investors. After two critical Government Accountability Office ("GAO") reports and an equally critical Congress, the SEC went after hedge funds and their helpers with a vengeance. Beyond this, as discussed below, the SEC--"the cop on the street"--does not spend much time walking this beat.

Hedge funds' Dominance of the Capital Markets Creates the Power to Abuse Them

The potential harm that hedge funds can inflict on other market participants has no real limits. Hedge fund trading now dominates the nation's capital markets. The $1.2 trillion under hedge fund management are on steroids. They recycle at high velocity through the markets. With that $1.2 trillion, hedge funds execute up to fifty percent of the daily trading on the $21 trillion New York Stock Exchange. They also do seventy percent of the trading in the US distressed debt market, US exchange-traded fund market and the convertible bond market. The same picture is emerging in the derivative markets. Patrick Parkinson of the Federal Reserve recently testified at a Senate hearing: "The active trading by hedge funds has contributed significantly to the extraordinary growth in past years in the market for derivatives (emphasis added)." So far, hedge funds have dominated these markets with only $1.2 trillion under management. But that is changing too. The SEC projects the hedge fund asset base will increase from $1.2 trillion to $6 trillion by 2015.

Hedge fund trading generates huge commissions and fees to investment banks and brokers. That revenue flow gives hedge funds influence with both brokers and investment banks. The Economist examined this growing influence in an article last year:

At a time when mutual and pension funds have become ever more reluctant to pay the traditional five cents a share for trades, hedge funds pay up to four times that amount if in the process they can receive good ideas or particularly effective execution....

And trading is just the beginning for banks. Hedge funds want hot issues, structured derivatives, margin, stock-lending for short sales and the equivalent for fixed-income, clearing and settlement, customer support and marketing. The money coming from all these transactions and fees is enormous....Although there is some overlap in the numbers, investment banks collected $15 billion either directly from hedge funds or because of them, producing $6 billion in profits. For individual firms, hedge funds were critical to last year's performance. They produced one-quarter of

Goldman Sachs's profits, estimates Guy Moszkowski of Merrill Lynch, and only a slightly smaller slug of Morgan Stanley's returns.

The revenue from hedge funds to investment banks was $25 billion for 2004. Since hedge fund assets under management continue to grow exponentially, hedge fund revenue to investment banks will do the same. Consequently, hedge fund influence with those banks will continue to grow as well.

The United Kingdom's Financial Services Authority ("FSA") expressed concern in June 2005 that hedge funds were getting more from investment banks than their contracts specified. According to the FSA, "insider trading is now institutionalized" because of the flow of tips from investment banks to hedge funds. The FSA "had uncovered signs of insider dealing at almost a third of British M&A deals, with possible culprits including traders at hedge funds and investment banks." That same month, the FSA also observed that hedge funds were "testing the boundaries of acceptable practice with respect to insider trading and market manipulation."

The illegal flow of insider information from investment banks to hedge funds was the primary focus of the hedge fund investigation I headed. Senior SEC officials halted the investigation, as I was told, because the suspected tipper had powerful political connections. Indeed, he does at the highest level. When I raised the propriety of that decision with the most senior Enforcement officials, they fired me. When I apprised Chairman Cox of these events, he did not lift a finger.

How Influence Peddlers Stopped a Critical Hedge Fund Investigation in Its Tracks

The investigation was two-pronged. The insider trading prong involved the securities of twenty public companies. On eighteen occasions, a Self Regulated Organization ("SRO") had referred the suspected insider trading matter to the SEC after conducting its own investigation. In each case, the hedge fund traded shortly before a public announcement sharply increased the value of its new holding. In all but two cases, the hedge fund made at least $1 million. Some referrals involved much larger profits. In two cases, evidence suggested the tip may have come from court personnel. In five cases, the hedge fund made highly profitable trades shortly before public announcements of acquisitions. In two of these cases, evidence indicated the tip had come from an investment bank.

The second prong of the investigation--market manipulation--involved two classes of suspected violations: wash sales and naked shorts. Some of my colleagues believed this prong held a greater potential to severely injure the capital markets. Evidence indicated that hedge funds used wash sales to spike stock prices just as unregulated pools used wash sales to spike stock prices in the 1920s. The investigation of both wash sales and naked shorts led to the hedge fund's prime broker, a large investment bank.

By May 2005, one of the insider trading matters dwarfed all others: the hedge fund's trading in two companies just before the announcement of a cash tender offer by one for the other at a 50% premium over the last trading price. The hedge fund profited by $18 million in 30 days. The evidence suggested that the hedge fund's CEO acted on an unlawful tip in directing the hedge fund's trades. But the question remained: who tipped him? In May 2005, Branch Chief Robert Hanson, directed me to spend all my time on the one matter and focus on finding the tipper. Accordingly, beginning in May 2005, I searched through millions of emails and other records for clues indicating who tipped the hedge fund CEO and, in June 2005, questioned the hedge fund's CEO--the suspected tippee--on this issue.

By mid-June, growing evidence pointed to one person: the former CEO of a large investment bank. The suspected tipper likely knew about the tender offer, spoke with the hedge fund's CEO just before he began to trade, profited by the trades, and had other personal and financial motives for tipping the hedge fund's CEO. The two suspects trusted each other, did financial favors for each other, and exchanged stock tips. The evidence yielded no other viable candidates.

My supervisors enthusiastically endorsed this factual theory of the evidence. On June 14, I briefed Branch Chief Hanson and Assistant Director Kreitman for one hour on the insider trading investigation, including the evidence that pointed to the suspect as the likely tipper. After which, they authorized me to present this same factual theory and evidence to the FBI and the US Attorney's office in New York, as the first step toward a possible criminal proceeding against both suspects. Accordingly, at a meeting the next day, I presented the information to an Assistant US Attorney and two FBI agents.

A few days after the meeting, I informed Branch Chief Hanson that I intended to issue subpoenas for the suspected tipper's examination and key documents. He first reacted positively to the suggestion. But a few days later, to my surprise, Hanson abruptly reversed course. Hanson blocked the issuance of subpoenas for the suspected tipper's testimony and records, stating that it would be difficult to obtain the authority to issue the subpoenas because the suspected tipper had powerful political connections.

Immediately after Hanson's comment, external interference with the investigation became evident. A high-powered attorney, Mary Jo White, bypassed the normal protocol of discussing the investigation with the assigned staff attorney. Instead, she went directly to Enforcement Director Linda Thomsen, despite the fact Director Thomsen had no prior involvement in the case. For the first time, senior staff left me out of meetings when they discussed the case. Associate Director Paul Berger--who had very limited knowledge of the facts--emphatically stated in my presence that no case would be filed against the suspected tipper, but gave no reason or clue for his decision. Emails between the suspected tipper and tippee that I had subpoenaed from investment banks were delivered by Mary Jo White to Director Thomsen. That had never happened before in the other 100 subpoenas I had issued. My supervisors, who had strongly supported the case only two weeks before, became angry and defensive when I tried to discuss the issuance of the subpoenas.

Most confounding, I could not understand how senior SEC officials would authorize me to meet with the FBI and the US Attorney to initiate a criminal investigation and then, two weeks later, block the issuance of civil subpoenas for the suspected tipper's testimony and key documents. The only significant occurrence between those two events was the decision of the US Attorney and the FBI to begin looking into the matter.

From late June until September 2, 2005, I informed every link in the chain of command from my branch chief to the SEC Chairman in over thirty written communications of the special and favored treatment my supervisors were giving to the suspected tipper. By way of example, I enclose a redacted copy of the letter I faxed to Chairman Cox on September 2, 2005. It never got a response. Neither Chairman Cox, nor Director Thomsen, nor Associate Director Berger ever questioned why the investigation was stopped.

If you wish to know more details how the SEC stopped the investigations, including supporting evidence, the identity of the suspected tipper and tippee, and the tipper's political connections, you may find this information in the 42-page sworn statement and 46 supporting exhibits I provided Kathy Casey, Esq., Staff Director and Counsel for the Senate Banking Committee, in mid-March 2006.

My Termination

On August 4, 2005, I sent the following email to Director Thomsen:

Do you have an open door policy?

If so, do you recall Hilton Foster's comment to you about the most important case he handled in his 30 years with the Commission? [As discussed earlier, Mr. Foster routinely taught incoming enforcement staff and foreign regulators how to conduct an insider trading investigation. He worked with me on the investigation from October 2004 until he retired on June 30, 2005.] He wanted me to talk to you about it. It was nearly killed 5 months ago and is now moving in circles.

It could change the financial markets--make them a little more hospital [hospitable] for investors, small or big, who do their home work rather than buy information with favors

The following day, my branch chief told me that senior staff would reconsider my recommendation to take the suspected tipper's testimony after he and I returned from vacation in September. I went on vacation two weeks later. On September 1, while on vacation, senior staff fired me.

My SEC performance evaluations

Until I questioned the suspected tipper's special treatment, my supervisors found my work met or exceeded all applicable SEC standards. They certified my performance met all applicable Enforcement standards for a staff attorney in June 2005. In mid-June 2005, Assistant Director Kreitman gave me his highest unofficial award for excellent work on the investigation. Later June, Branch Chief Hanson prepared his assessment of my 2004-2005 performance for a possible merit step increase. Just before the controversy over investigating the suspected tipper arose, Hanson praised my work on the hedge fund investigation, stating:

Gary has an unmatched dedication to this case (often working well beyond normal work hours) and his efforts have uncovered evidence of potential insider trading and possible manipulative trading by the fund and its principals. He has been able to overcome a number of obstacles opposing counsel put in his path on the investigation. Gary worked closely with the Office pf Compliance Inspections and Examinations to develop the case and worked with several self-regulatory organizations to develop a number of potential leads. He has gone the extra mile, and then some.

Consequently, on August 21, 2005, the SEC approved my two-step merit increase based on my handling of the hedge fund investigation. The SEC terminated my employment eleven days later on one day's notice. According to the SEC union president, the SEC's decision in my case to award a merit pay increase and then terminate my employment is unprecedented.

SEC's Dismal Record Protecting Market Participants from Hedge Fund Fraud

How the SEC Learned Hedge Funds Cheat Others; the Mutual Fund Scandal

For twenty-five years, from 1979 to 2004, hedge fund fraud and manipulation operated under the SEC's radar. The SEC brought no cases against hedge funds for manipulation, insider trading, or fraud directed against other market participants. During this period, the SEC recognized only one species of hedge fund fraud: that committed by a hedge fund against its own investors. The SEC first publicly recognized that there were two classes of hedge fund fraud in July 2004. Its proposed rule requiring hedge funds to register noted: "Since the staff report [of September 2003], a new species of hedge fund fraud has been uncovered (emphasis added)."

So, how did senior SEC officials figure out after twenty-five years that hedge funds were also cheating other market participants? Well, as a matter of fact, they did not. A state attorney general announced the settlement of the first case involving a pattern of hedge fund fraud on other market participants. It was the first hedge fund caught for pilfering mutual fund accounts, the investment vehicle of choice for tens of millions--the classic small investor. As for the SEC--"the cop on the street"--it caught nothing.

The total cost to mutual fund investors was staggering. According to Time Magazine, "Academics estimate that late trading costs investors $400 million a year and market timing $4 billion to $5 billion." According to The Wall Street Journal, "[H]edge funds ...reaped the lion's share of gains from the [unlawful] trading." In March 2005, the SEC was investigating 400 hedge funds for their participation in the scam.

The SEC Also Failed to Catch the Helpers--Yet Another Industry it Regulated.

Hedge funds could not have skimmed mutual fund accounts without help. That is just what they got from the brokers the SEC also regulates. "Thirty percent of the brokerage firms the SEC surveyed helped clients mask market-timing trades, either by breaking up big orders or creating special accounts to hide identities." On top of that, "70 percent of the brokers said they were aware that some of their customers were timing the market." They just looked the other way. The SEC survey showed that twenty-five percent of brokerage companies allowed late trading. Late trading occurs where a hedge fund puts in a trade after the funds' 4 p.m. cutoff, but gets the pre-4 p.m. price. Some have likened it to betting on a horse race after it has been run. Some of those brokers who helped hedge funds pilfer mutual fund accounts were the brokerage arms of large investment banks like Bear, Stearns, & Company, Merrill Lynch & Company, and CIBC.

To sum up, the SEC was oblivious that hedge funds cheated other market participants for twenty-five years. The SEC somehow overlooked a hedge fund scam that cost mutual fund investors billions of dollars per year. The scam was executed for years with the participation of two industries the SEC also regulates: mutual funds and brokers. It would not listen to a whistleblower who was armed with the facts. Eventually, like the public, the SEC learned about the scandal when a state attorney general announced a $30 million settlement. How has the SEC done since then to detect hedge fund fraud that victimizes other market participants?

The PIPE Cases

Over the past year, the SEC has brought three cases for a new type of hedge fund fraud that victimizes other market participants. All three involved a very specific form of insider trading. The facts follow the same pattern. A public company decides to raise money by making a private placement of its stock with the intent to register the stock a few months later. This is commonly known as a private investment in public equity or PIPE. A hedge fund agrees to purchase stock through the placement. The hedge fund also knows that the public announcement of the PIPE will depress the market price of the stock. Knowing that, the hedge fund shorts the company's stock and covers it with the private placement for a quick and sure profit. In executing the short, the hedge fund acted on material nonpublic information and violated the securities laws.

Once again, the PIPE cases demonstrate the same old SEC enforcement patterns. The cop on the street--the SEC--did not detect this pattern of insider trading. Rather, it was detected by a $100 billion mutual fund and the evidence was then handed over to SEC officials.

In handling the PIPE cases, the SEC again wore blinders. The SEC has twenty-seven PIPE cases; it has filed three; it is investigating twenty-four others. Again, the PIPE cases demonstrate a pattern of insider trading by hedge funds. This pattern raises the obvious question: If hedge funds are willing to trade on nonpublic material information in one situation, might they not be doing the same in others? For example, are they getting tips from investment banks of pending acquisitions before they are publicly announced? Do hedge funds have techniques for obtaining tips, e.g., next quarter's earnings from public companies before they are publicly announced?

The SEC should be able to check for this. It receives a constant flow of suspected insider trading referrals from SROs. The NASD, NYSE, and AMEX all have market surveillance units that track the market daily for suspicious trades, including insider trading. When their computers detect suspicious trading, the SRO's staff does its own review and, if the trading appears suspicious, refers the matter to the SEC. Many of those referrals involve hedge funds suspected of insider trading.

But that system breaks down when it comes to referrals involving insider trading by hedge fund. Those referrals are rarely, if ever, investigated, unless they happen to meet the PIPEs cookie cutter mold. The investigation I conducted was an anomaly. The right person at intake found the right senior SEC official. That matter was assigned to me. I then found thirteen other insider trading referrals on the same hedge fund that had been gathering dust. None had been investigated other than a cursory review. No one had looked at the referrals collectively for any patterns.

The institutionalized form of insider trading by hedge funds insidiously erodes the integrity of the stock markets. The concept is best illustrated with an analogy. Imagine a sports arena with thousand small boxes organized in rows on the arena floor. Each box contains an egg: some are Faberge, others gold, others silver and on and on gradually to the rotten eggs. Egg buyers--some sophisticated; some not--carefully inspect the exterior of the boxes for clues to their contents. None may peak inside. The inspection ends at 5 p.m. All egg buyers exit the arena, notes in hand, ready for tomorrow's auction. In the early hours, a security guard allows a team of egg buyers to enter the arena, open the boxes and survey their contents. The public auction of the boxes begins at 10 a.m. sharp. With their survey notes, the early morning team pays richly for the boxes containing the Faberge, gold and silver eggs and craftily avoids those with lesser value. The sophisticated egg buyers are puzzled why their boxes never contain the prized eggs.

My point is this: those that use insider trading cheat all investors--the most sophisticated institutional investor and the small investor alike. They cherry pick the market and, in so doing, undermine the integrity of the capital markets. They rig the game. One senior executive of a $97 billion mutual fund put it this way: "For the last five years, the hedge funds have gotten a free pass,...it's damn well time that they're held accountable to the capital market rules, which were created to protect companies and investors to know that the game isn't rigged." For the sophisticated investor, there are two options: continue to be victimized or join the early morning team.

The Most Recent Statement of the SEC on Policing Hedge Fund Abuse

The most recent testimony from the SEC on its efforts to police hedge fund abuse was given on May 16, 2006, before the Senate Subcommittee on Securities and Investment. Given the growing concern on this subject, this was a golden opportunity for a senior SEC official, perhaps from its Enforcement Division, to tell what new steps the SEC has implemented to protect market participants from hedge fund abuse. Instead, the SEC sent its Director of Investor Education, Susan Wyderko, as if to say that hedge fund abuse is merely a matter of educating investors. She was of course unable to give meaningful testimony or respond to the obvious questions.

Ms. Wyderko's written testimony offered a ray of hope. It cited three "recent significant cases" to demonstrate the SEC "has taken appropriate remedial legal action" against hedge funds for "market abuse." Unfortunately, those cases merely confirm the analysis above that the SEC has no new thought for dealing with hedge funds. The first cited case is a classic market timing-late trading case. The second was a classic PIPE case.

That leaves the SEC's handling of the third case, which would be funny, if the SEC were not offering it as an example how it is protecting market participants from hedge fund abuse. In that case, the media began detailing the transparent scheme of Scott Sacane and his hedge fund to manipulate two small biotech stocks in July 2003. The media continued to do so for more than two years until the SEC finally filed its enforcement action in October 2005. The SEC complaint borrowed allegations made by The Wall Street Journal two years earlier, but left out the humor. On July 30, 2003, the Wall Street Journal published this account of Mr. Sacane's trading:

Thursday, Mr. Sacane disclosed that his health-care fund... "inadvertently" had bought a majority stake in a small medical-products company called Aksys. Monday, Durus filed that it owned 77% of Aksys, whose stock has been plummeting for days on the news. Mr. Sacane insisted that the investment is passive.

But Mr. Sacane, who declined to comment, didn't stop his "inadvertent" buying there. He also "inadvertently" bought a 33% stake of Esperion Therapeutics.

So what exactly did the SEC uncover over the next two years? Its complaint alleges: "The statement [Sacane's purchase was inadvertent] was false because the Sacane Defendants knew about their Aksys stock purchases all along, and those purchases were not inadvertent." How could it take the SEC two years to deduce the same point any reader of The Wall Street Journal article immediately understood? If this case were a movie, it would be titled The Keystone Kops meet the Gang that Couldn't Shoot Straight.

Conclusion

No new legislation or regulation can protect market participants from hedge fund abuse unless the SEC does its job. By any measure, it has not. The SEC failed to detect that hundreds of hedge funds were siphoning billions of dollars from mutual fund investors. It also failed to detect a second pattern of hedge fund abuse--the PIPE insider trading. Its conduct and words give no reason to believe it will detect other hedge fund abuses of market participants.

And then there is the obvious. One SEC investigation picked up the trail of several patterns of hedge fund market abuse. One prong included suspected insider trading in twenty public companies. The other found evidence of numerous wash sales and naked shorts. Both prongs led to the hedge fund's connection with its prime broker. If the prime broker was involved in any of the violations, as appeared to be the case, the investigation would have had implications for the whole hedge fund industry. In sum, it was the only SEC investigation to put a high beam on the shadowy juncture where hedge funds and investment banks do their lucrative business.

Just after the SEC authorized the investigation to be presented to federal prosecutors and the FBI for possible criminal prosecution, senior SEC Enforcement officials blocked the issuance of civil subpoenas for the suspected tipper's testimony and key documents. No insider trading case can be filed without proof of the source of the tip. Thus, stopping the investigation of the likely tipper stops the investigation. In so doing, the SEC has given hedge funds and investment banks notice that it will not police their joint activities. The SEC could do no greater disservice to other market participants and especially the small investor. This is not mere incompetence.

It is not surprising that the U.S. Office of Management and Budget (OMB) gave SEC Enforcement its lowest performance assessment: "Results Not Demonstrated." According to the OMB, "that rating indicates that [Enforcement] has not been able to develop acceptable performance goals or collect data to determine whether it is performing." In short, whether or not Enforcement performs is an unknown. And it is an unknown because it has no goals or data. That criticism is aimed at the top. No matter how committed and competent the SEC staff works the trenches, and that was my experience, they cannot achieve the SEC's mission without leadership equally committed to that mission.

Is there more hedge fund abuse on the horizon? Logic says yes. In the mutual fund scandal, hedge funds broke legal and moral boundaries to make billions in profits at the expense of small investors. In doing so, hedge funds compromised two financial industries--mutual funds and brokers. It seems implausible that hedge funds would suddenly recognize those boundaries if other opportunities arose to make a fast dollar without getting caught. The PIPE cases are just one more example that hedge funds break the law in packs.