SEC Focusing Enforcement Resources on Hedge Funds

Background: On July 31, 2007, SEC Chairman Christopher Cox unveiled the creation of a new 25 person hedge fund task force within the Division of Enforcement. While a hedge fund working group was formed over a year ago in the SEC’s New York Regional Office, Chairman Cox’s announcement expands this enforcement initiative to the SEC’s home office in Washington, D.C., and all 11 of its regional offices nationwide. This task force is dedicated to scrutinizing hedge funds and how they operate, with a focus on various enforcement issues peculiar to hedge funds. Thus, hedge fund managers must stay abreast of the latest SEC staff interpretations and enforcement actions that affect their business practices. And, they must be prepared should they receive a request from the Division of Enforcement.

Enforcement Priorities: To date, the SEC’s enforcement activity against hedge funds has centered on insider trading violations, short-selling in anticipation of a public offering, and fraud relating to “collateralized debt obligations” of subprime hedge funds.

First, the SEC has already sent expansive document requests to hedge funds. Such requests appear to be part of a specific effort to crack down on insider-trading violations by hedge funds and/or the accounts they control.

Second, the SEC has brought a number of enforcement actions against hedge funds and their managers for engaging in illegal short-selling schemes. One such scheme involves a PIPE (“private investment in public equities”) offering, which is used by a company to raise capital as an alternative to a registered public financing. PIPE investors are alleged to have sold short the PIPE issuer’s securities and then used PIPE shares to cover the short positions—a practice which the SEC takes the view is prohibited by the registration provisions of the federal securities laws.

Finally, in the wake of the subprime lending crisis, the SEC is preparing to take the offensive against subprime hedge funds. Chairman Cox confirmed in June that the SEC had begun nearly a dozen enforcement inquiries into “collateralized debt obligations,” in which some hedge funds have invested heavily. And the SEC has already booked one settlement, when First Bancorp agreed to pay $8.5 million to settle fraud charges. The SEC alleged First Bancorp created and backdated certain documents and affirmatively misrepresented to its auditor (and investors) the terms of $4 billion worth of residential mortgage-related transactions to avoid a restatement, and aided and abetted securities violations by Puerto Rico’s top mortgage lender between 2000 and 2004.

Conclusion: Hedge funds are a prime enforcement target for the SEC. Funds should ensure through discussions with experienced SEC counsel that they are prepared for possible SEC investigations. Funds need to have counsel ready to respond to SEC information requests and subpoenas, and to conduct efficient and thorough internal reviews when necessary to stay one step ahead of the regulator’s concerns.

Covington’s Securities Enforcement Practice: Covington’s securities enforcement practice is led by former high level SEC enforcement attorneys and senior federal prosecutors. In Washington, D.C., the group is headed by Bruce A. Baird, former Chief of the Securities Fraud Unit of the United States
Attorney’s Office for the Southern District of New York. In San Francisco, the group is led by David B. Bayless, former District Administrator for the San Francisco office of the Securities and Exchange Commission. Finally, in New York, the group is spearheaded by Aaron R. Marcu, former Associate United States Attorney and Chief of the Major Crimes Unit of the United States Attorney’s Office for the Southern District of New York.

Covington lawyers have handled scores of SEC and FINRA enforcement investigations and dozens of jury trials in federal and state court and many more appeals. We conduct internal investigations for corporate clients and other entities, help design corporate compliance programs and oversee mock SEC examinations. We routinely team with members of the Firm’s Securities Practice Group on disclosure, corporate accounting and other compliance-related issues. This group includes David B.H. Martin, former Director of the Division of Corporation Finance of the SEC.

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If you have any questions concerning the material discussed in this client e-alert, please contact the following members of our SEC Enforcement practice group:

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