

**UPDATE**

August 10, 2007

**SEC TURNS UP HEAT ON HEDGE FUNDS**

On July 31, 2007, SEC Chairman Christopher Cox announced the creation of a new hedge fund task force within the Enforcement Division as the Commission's latest effort to "enhance its efforts to combat hedge fund insider trading." Although no other details were disclosed with respect to the new unit's formation, the creation of a task force dedicated to scrutinizing hedge funds suggests a greater need for fund managers to stay abreast of the latest SEC staff interpretations that may affect business practices.

**Rule 10b-5**

Hedge funds should consider the potential application of Rule 10b-5, one of the cornerstones of the SEC's enforcement program, to certain hedge fund business practices. Rule 10b-5 makes it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility or any national securities exchange: (1) to employ any device, scheme, or artifice to defraud, (2) to make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The following are three examples that illustrate Rule 10b-5's broad potential application to hedge fund activities.

**Big Boys**

The Enforcement Division of the SEC may seek to apply Rule 10b-5 to activities generally referred to as "big boy" practices. Pleadings in a recent lawsuit filed by R<sup>2</sup> Investments ("R<sup>2</sup>") against Solomon Smith Barney ("SSB") may indicate how "big boy" practices may come under Rule 10b-5 scrutiny. According to pleadings in the litigation, SSB engaged in negotiations with World Access, Inc. with respect to the terms of a tender offer. Through these negotiations, SSB allegedly learned material, non-public information about World Access. Afterwards, SSB sold its position to Jefferies Group under a "big boy" letter. Jefferies later sold the notes to Fimat Group, without a "big boy" letter, which in turn sold them to R<sup>2</sup> without a "big boy" letter. Two days after the sale by SSB, World Access made public the material, non-public information available to SSB, causing a significant decline in the value of R<sup>2</sup>'s investment. R<sup>2</sup> filed suit against SSB alleging that the "big boy" letter did not inoculate SSB from 10b-5 liability. Although the matter is still pending, SSB's efforts to dismiss the 10b-5 allegations have failed.

Although not an SEC enforcement action, the lawsuit by R<sup>2</sup> suggests a possible 10b-5 application to the "big boy" practice used by hedge funds.

**Material, Non-Public Information**

Barclays Bank recently paid over \$10 million to settle an SEC Enforcement Action alleging trading violations under Rule 10b-5. This enforcement action suggests that hedge funds should be mindful of their trading activities when possibly in possession of material, non-public information. According to the SEC complaint in this matter, Barclays obtained material, non-public information through its membership to creditors committees of various issuers. Notwithstanding the confidentiality agreements Barclays signed, the SEC alleged that over an 18 month period, Barclays unlawfully traded in the securities of the various issuers.

Membership to a creditors committee, or any other group or committee that enables hedge funds to access material, non-public information, may prohibit trading in the securities of the issuer. These prohibitions, however, can be avoided if hedge funds erect firewalls between the trading desks and the individuals in possession of material non-public information.

### **"In Connection With"**

In 2005, the SEC alleged Rule 10b-5 violations against Van D. Greenfield and Blue River Capital LLC in connection with WorldCom's chapter 11 bankruptcy cases. According to the SEC's administrative order imposing sanctions, Greenfield (Blue River Capital's manager and compliance officer) caused Blue River Capital to enter into simultaneous backdated purchases and short sales of WorldCom unsecured notes. In order to gain appointment to WorldCom's official unsecured creditors' committee, Greenfield never disclosed to the U.S. Trustee the existence of the short sale order, or that the trades had not yet settled. After being appointed to the committee, Greenfield cancelled the short sale and associated purchase of the notes. Even though the purchase and short sale did not directly involve any party other than the trade counterparties, the SEC alleged that by failing to disclose its true ownership position in unsecured notes to obtain membership on WorldCom's creditors' committee, Greenfield and Blue River Capital violated Rule 10b-5 by making indirect misrepresentations to all WorldCom constituencies in connection with the purchase and sale of securities.

The Blue River Capital enforcement action should encourage hedge funds to consider whether any of their trading and corresponding disclosure activities could be subject to allegations of Rule 10b-5 violations.

### **Take Aways**

The formation of a hedge fund task force indicates that the SEC staff may scrutinize certain hedge fund business practices, and may increase the likelihood of regulatory action in the hedge fund arena. The actions against SSB, Barclays and Blue Water Capital are just a few examples of Rule 10b-5's application to certain trading activities. In the past year, the SEC has brought numerous enforcement actions against hedge funds alleging violations of 10b-5. Given the sweeping reach of Rule 10b-5, it would be wise for hedge fund managers and other market participants to discuss their current strategies with counsel before the SEC strikes.

The Bracewell & Giuliani White Collar Criminal Defense and Special Investigations Group possesses the experience necessary to handle any regulatory inquiry. Our lawyers include former senior staffers in the SEC Enforcement Division and the U.S. Department of Justice and currently focus on advising hedge fund clients. When teamed with the attorneys of Bracewell's Private Investment Funds Practice, Bracewell is capable of advising you on all aspects of the issues raised above.

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