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Conflicts of Interest

SEC Accuses Brokers and Hedge Fund Advisers of Alleged Bribery Scheme

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By Alisa Greenstein, *Hedge Fund Law Report*

On March 12, 2009, the SEC filed suit in the United States District Court for the Southern District of New York accusing a broker-dealer firm, Granite Financial Group, LLC, and two brokers, Daniel Schreiber and David Harrison Baker, of allegedly bribing two employees of the hedge fund investment adviser JLF Asset Management LLC (JLF), Brian Travis and Nicholas Peter Vulpis, Jr., also named in the suit, in exchange for their routing of hedge fund trades to the brokerage firm. The SEC charged defendants with various violations of the federal securities laws and sought injunctive relief, disgorgement plus prejudgment interests and civil penalties.

Allegations in the Complaint

According to the complaint, Schreiber, a registered representative for the broker-dealer Granite, Baker, an associate of a broker-dealer located in Jericho, New York, and A.G., a registered representative of broker-dealer B, all provided Travis and Vulpis with personal services for directing trades from JLF's hedge fund clients to them. With regard to defendants Granite, and its associate Schreiber, the SEC accused them of providing $168,605 worth of travel and various personal services to Travis and Vulpis between March 2003 and October 2005 in return for which Travis and Vulpis directed JLF trades to Schreiber and Granite. Schreiber profited personally from the commissions Granite earned for each trade. As an apparent result of the scheme, the JLF Funds became Granite's single largest customer in 2004, and Granite earned over $10 million in commissions. Schreiber also failed to disclose the various expenses it and Granite paid on Travis' or Vulpis' behalf, notwithstanding his manually signed attestations that he was in compliance with NASD Rule 3060, including the prohibition against giving items of value in excess of $100.

The SEC similarly accused defendant Baker of agreeing sometime around October 2004 to pay certain personal expenses of Travis and Vulpis, including luxury vacation travel, in exchange for Travis and Vulpis directing trades for the JLF Funds to Baker, an agreement which they executed simultaneously. Baker did not inform his employer, the broker-dealer, about this arrangement. In 2004 and 2005, the JLF Funds paid Baker's broker-dealer over $950,000 in commissions, half of which were paid to Baker personally. During the same time, Baker paid over $72,000 in travel expenses for Travis.

Finally, the SEC accused Travis and Vulpis of receiving payment between March 2003 and December 2004 for similar types of personal travel expenses, including a personal car service, from A.G., a registered representative associated with Broker-Dealer B. Just as with Baker and

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Schreiber, the trades for the JLF Funds that Travis and Vulpis directed to A.G. and Broker-Dealer B were made in exchange for these substantial personal expense payments. During 2003 and 2004, Broker-Dealer B received over $2 million in commissions from JLF. In October 2004, A.G. learned that the SEC was examining Broker-Dealer B and particularly its travel procedures. A.G. promptly asked Vulpis for reimbursement for the car service. Vulpis refused to reimburse Broker-Dealer B for the car service. Shortly thereafter, JLF's trading business with that broker-dealer declined significantly.

The SEC maintained that defendants concealed their scheme from the JLF Funds. In particular, Travis and Vulpis used a mechanism called "net trades" to conceal the amount of commissions and trading they directed to Granite, Baker's broker-dealer and to Broker-Dealer B. By using net trades, Travis and Vulpis could include the commission for executing the trades as part of the transaction cost for that trade (i.e., included in the price of the security) without having to separately identify the commission to the SEC or the hedge funds. At Travis' and Vulpis' request, Granite, Baker's broker-dealer, and A.G.'s broker-dealer executed many of JLF Funds' trades on a net trade basis. Since the actual commissions charged remained hidden, Travis could present a false and deflated picture of the commissions the JLF Funds paid these brokers.

Travis and Vulpis also misled JLF's managing member and founder, Jeffrey Feinberg, into concluding that the level of trades directed to Baker, Schreiber, Granite and the other registered representatives and broker-dealers was much lower by providing him with misleading monthly e-mails containing the erroneous commission reports. These reports identified only explicit commissions paid during the period and excluded from both calculations (total and by individual broker) any commission paid on a net trade basis during the period. Travis and Vulpis purportedly knew of the deceptive nature of these reports, and that JLF omitted disclosure of this material information to the JLF Funds. Travis and Vulpis also defied Feinberg's instructions, including his directives to steer trades away from some of these broker-dealers, to conceal their arrangements. In December 2003, Feinberg advised Vulpis that he should decrease the commissions the JLF Funds paid to Broker-Dealer B. One month later, Vulpis and Travis switched its trading with Broker-Dealer B from the explicit commission basis to the net trade basis, to conceal the commissions.

Schreiber and Granite also knew that Travis and Vulpis had misled Feinberg and the JLF Funds about the commissions Granite received. Schreiber was aware, for example, that Travis and Vulpis disseminated misleading reports regarding the level of trading directed toward Granite. Travis and Vulpis also concealed the bribes they received in exchange for directing JLF Funds' trades to the various broker-dealers. Apparently, both Baker and Schreiber also knew that Travis and Vulpis concealed the bribes from the JLF Funds.

Aiding and Abetting JLF's Failure to Disclose Material Conflicts of Interest

Travis and Vulpis, as JLF employees, purportedly concealed the conflicts of interest their bribery scheme created from JLF's hedge fund clients. As a result, JLF did not disclose to its hedge funds these material conflicts despite the fact that JLF, as an investment adviser, owed a duty to the JLF Funds to disclose any material conflict. Thus, the SEC alleged that Travis and Vulpis aided and abetted JLF's failure to disclose material conflicts of interest to its clients.

Charges in the Complaint

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Based on these allegations, the SEC brought claims against the defendants for their violations of Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 thereunder, and for aiding and abetting JLF's violations of Sections 206(1) and 206(2) of the Investment Advisers Act of 1940. The SEC seeks injunctive relief, disgorgement plus prejudgment interests and civil penalties against the defendants.

The text of the SEC's complaint is available at

http://www.sec.gov/litigation/complaints/2009/comp20948.pdf.

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