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# Hedge Fund Managers with Unexplained Aberrational Performance Are More Likely to Become Targets of SEC Enforcement Actions

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In a December 1, 2011 press release, the Asset Management Unit of the SEC's Division of Enforcement (Division) announced the Aberrational Performance Inquiry (Inquiry), a new initiative to identify and combat hedge fund fraud. Under the Inquiry, the Division is using proprietary risk analytics to screen hedge funds' performance returns to determine whether the stated returns are consistent with the fund's investment strategy or appropriate benchmarks. If the Division identifies a hedge fund whose performance is aberrational – too high, too low or inconsistent with the fund's strategy – the Division is likely to undertake additional quantitative and qualitative screens to determine the source of the aberration. Such screens may include contacting the fund's manager directly, looking more closely at the sources of stated returns and examining factors other than returns. For more on the Inquiry based on information that was publicly available as of April of this year, see "SEC's Hedge Fund Focus to Include Review of Funds That Outperform the Market," Hedge Fund Law Report, Vol. 4, No. 14 (Apr. 29, 2011).

The Division has emphasized that the Inquiry is not an effort to penalize good performance. And, indeed, the technology being used by the Division, the manner in which the Division is using that technology and the Division's vigorous ongoing efforts to communicate with the industry all suggest that good performance will not increase the likelihood of an enforcement action against a hedge fund manager based solely on good performance. Rather, the legal thesis underlying the Division's new use of technology is that various bad acts – for example, valuation fraud, style drift and various conflicts of interest – will manifest themselves in aberrational performance. Therefore, while aberrational performance is not, by itself, conclusive evidence of bad acts, it can be evidence that further investigation is warranted. Viewed in this light, the Inquiry is a more systematic method of allocating the Division's finite enforcement resources.

Since its creation almost two years ago, the Asset Management Unit has brought a steady clip of enforcement actions against hedge fund managers alleging a wide range of causes of action. The Inquiry offers a unifying principle for understanding many of these actions. While the causes of action are different, the analytic process used by the Division to identify the targets of the actions is the same. The Division's December 1, 2011 press release identifies four recent enforcement actions that were brought as part of the Inquiry. Those four actions are not all of the actions that have been brought based on the Inquiry. Rather, the intent of the press release is to illustrate: the range of claims that has resulted from the Inquiry; the effectiveness of the methods being used in the inquiry; the fact that the Inquiry targets both registered and

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unregistered hedge fund advisers, and managers across the AUM spectrum; and that good performance alone is not illegal.

The Hedge Fund Law Report has covered each of the four enforcement actions discussed in the press release. First, we covered the SEC's action against ThinkStrategy Capital Management and its principal, Chetan Kapur, in our issue of November 23, 2011. See "Private Lawsuits Against Hedge Fund Managers Can Be Important Sources of Examination and Enforcement 'Leads' for the SEC," Hedge Fund Law Report, Vol. 4, No. 42 (Nov. 23, 2011). In addition, we previously covered a private lawsuit against ThinkStrategy and Kapur. See "Federal Court Decision Holds that a Fund of Funds Investor May Sue a Fund of Funds Manager That Fails to Perform Specific Due Diligence Actions Promised in Writing and Orally," Hedge Fund Law Report, Vol. 4, No. 27 (Aug. 12, 2011). Second, we covered the SEC's action against Solaris Management and its principal, Patrick Rooney, in last week's issue. See "Recent SEC Enforcement Action Provides a Dramatic Example of Style Drift in the Hedge Fund Context," Hedge Fund Law Report, Vol. 4, No. 43 (Dec. 1, 2011). Third, this article details the factual and legal allegations in the SEC's administrative proceeding against unregistered investment adviser LeadDog Capital Markets LLC (LeadDog) and its general partners and owners, Chris Messalas and Joseph LaRocco. This article also discusses specific lessons to be drawn by hedge fund managers from the LeadDog matter. And, fourth, another article in this issue of the HFLR details civil valuation fraud allegations brought by the SEC, and parallel criminal charges brought by the DOJ, against the former portfolio manager of the Millennium Global Emerging Credit Fund. On the liquidation of that fund, see "When Can the Liquidators of Non-U.S. Hedge Funds Access U.S. Bankruptcy Courts to Obtain Ancillary Relief for Fund Investors?," Hedge Fund Law Report, Vol. 4, No. 32 (Sep. 16, 2011).

## Background of the LeadDog Matter

On November 15, 2011, the SEC instituted an administrative proceeding against LeadDog, Messalas and LaRocco charging them with fraud in connection with a hedge fund they sponsored, LeadDog Capital LP (Fund). The SEC's Order in the matter alleges that from approximately November 2007 until August 2009, LeadDog and its principals raised approximately $2.2 million for the Fund from twelve investors. Messalas and LaRocco jointly owned and controlled the Fund's investment adviser. The principals indicated in marketing materials that the Fund would invest in domestic and international securities, equities, debt instruments, convertible securities, options and derivatives. However, the Fund allegedly invested almost entirely in illiquid penny stocks and microcap stocks, most of which had received "going concern" opinions from their auditors and were owned or controlled by the principals or their affiliates. The portfolio companies suffered significant financial losses.

The SEC alleges that LeadDog and the Principals made a number of material misrepresentations and omissions to investors. For instance, in or about February 2009, the principals represented to an elderly investor (Investor A) in a written response to a due diligence questionnaire (DDQ) that at least half of the Fund's assets were liquid and could be marked to market on a daily basis, other assets would be valued in accordance with U.S. generally accepted accounting principles and Investor A could withdraw from the Fund at any time. For more on due diligence, see "Twelve Operational Due Diligence Lessons from the SEC's Recent Action against the Manager of a Commodities-Focused Hedge Fund," Hedge Fund Law Report, Vol. 4, No. 11 (Apr. 1, 2011). As a result, Investor A invested approximately $500,000 in the Fund, representing approximately 15 percent of the Fund's total capital. The SEC alleges that, in fact, approximately 92 percent of the Fund's assets were in illiquid investments, and none of those investments could be marked to

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market. Additionally, when Investor A learned in or about August 2009 that the Fund was heavily invested in illiquid securities, he requested a withdrawal of his assets. However, the principals did not redeem the vast majority of Investor A's investment because of a lack of liquid assets to pay out withdrawal proceeds.

The SEC also alleges that LaRocco, at Messalas' direction, supplied misleading information to several hedge fund databases (Hedgefund.net and Hedgeco.net) about Messalas' disciplinary history and the Fund's operations in response to questionnaires submitted by the database companies. These databases provide background, performance and other information about hedge funds and managers, and the SEC alleges that they knew that the databases would serve as a conduit to disseminate information supplied to them. Regarding Messalas' disciplinary history, Messalas had been involved in one National Association of Securities Dealers arbitration, and a broker he was associated with had been repeatedly fined, censured and expelled by the Financial Industry Regulatory Authority (FINRA). On FINRA arbitration, see "U.S. District Court Evaluates FINRA Arbitration Decision in High-Stakes Severance Dispute Between UBS and Former Portfolio Manager," Hedge Fund Law Report, Vol. 4, No. 41 (Nov. 17, 2011). The SEC also alleges that the principals lied when submitting answers to questions posed by the the database companies about the Fund's administrator. For a discussion of another enforcement action alleging provision of false information to third-party hedge fund information providers, see "Fourteen Due Diligence Lessons to Be Derived from the SEC's Recent Action against a Serial Practitioner of Hedge Fund Fraud," Hedge Fund Law Report, Vol. 4, No. 25 (Jul. 27, 2011). The SEC alleges that the principals did not disclose to the database companies that the administrator of the Fund was not independent from the sponsors. Rather, LeadDog itself initially served as its own administrator, then administrative functions were transferred to another entity jointly owned by the principals. The SEC also alleges that the principals supplied similarly misleading statements in responses to Investor A's DDQ.

The SEC similarly alleges that the principals supplied misleading information to their auditor in a management representation letter about related party transactions and conflicts of interest. For instance, the SEC alleged that the principals failed to disclose to investors or in the management representation letter that they collected fees and payments for services in connection with the Fund's investment activities from the Fund other than the disclosed two percent management fee. Such fees included legal fees collected by LaRocco in connection with the Fund's investment activities and "structuring and due diligence" fees received by Messalas and LaRocco in connection with the Fund's investments. In addition, the SEC alleges that the principals failed to disclose that the Fund made investments in companies in which Messalas had a substantial ownership interest. In addition, the SEC alleges that the principals failed to disclose that the Fund also made investments in companies that were controlled by persons connected with the principals, including Messalas' sister-in-law. As a result of these false misrepresentations in the management representation letter, the auditor issued a clean audit report, which the principals disseminated to investors and prospective investors as part of the package of marketing materials.

## Violations and Remedies Sought

Based on the foregoing factual allegations, the SEC charged:

- LeadDog and the principals with violating Section 17(a) of the Securities Act of 1933 (Securities Act) and Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and

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Rule 10b-5 thereunder which respectively prohibit fraud in the offer and sale of securities and in connection with the purchase or sale of securities;

- Messalas and LaRocco with aiding and abetting LeadDog's violation of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder;
- Messalas and LaRocco with violating Section 206(4) of the Investment Advisers Act of 1940 (Advisers Act) and Rule 206(4)-8 thereunder which prohibits fraud with respect to any investor in a pooled investment vehicle;
- Messalas with aiding and abetting LeadDog's violation of Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder; and
- LaRocco with aiding and abetting LeadDog's and Messalas' violation of Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

The SEC seeks a permanent injunction, disgorgement and civil penalties against LeadDog and the principals. In addition, the SEC seeks to bar LaRocco from appearing or practicing before the SEC as an attorney, which he had done in the past.

## Implications of the LeadDog Action for Hedge Fund Managers

The LeadDog action suggests that the SEC is actively using numerous channels to gather information about hedge funds to ferret out fraud. This likely includes monitoring hedge fund databases that collect performance information supplied by managers and make such information available to investors and others for a fee. The SEC has not specified the sources of performance information used to establish the "baseline" against which aberrational performance is measured. Similarly, the SEC has not publicly discussed how it obtains performance information for individual funds or managers. However, the LeadDog matter and other enforcement actions strongly suggest that at least one source of performance information used by the SEC in the Inquiry is commercial hedge fund performance databases. Therefore, managers should keep in mind when reporting to such databases that the information is not only being used for a sales purpose, but likely is also being used for regulatory monitoring. Notably, this does not merely mean that managers should submit such information with additional pages of disclaimers. From the Division's perspective, performance information speaks for itself. Accordingly, this means that managers should take a hard look at the performance information they are submitting and be ready to explain that information to the Division. Managers should also ensure that performance information submitted to databases is consistent with performance information in fund documents provided to investors (e.g., PPMs, DDQs, LPAs, brochures, etc.) and documents filed with regulators (e.g., Form PF, Form ADV, etc.).

In addition, while the specific analytics being performed by the SEC are proprietary, hedge fund managers may try to undertake or approximate a similar process on their own in order to determine whether their performance may be perceived as "aberrational." Accurately anticipating what the SEC will consider "aberrational" and identifying appropriate benchmarks may be difficult; and both likely will require input from divisions of the manager beyond portfolio management, including risk management, compliance and operations. However, the process is worth undertaking. As indicated, the SEC is likely to contact managers with aberrational performance and those who can coherently explain the sources of such performance are likely to be left alone whereas those who give confused or conflicting answers may become the subject of enforcement actions. In addition, developing processes for buttressing performance and

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valuation claims is a good discipline for a manager – it can enhance the quality of the manager's infrastructure, which can pay dividends during investor due diligence and regulatory examinations.

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