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Allocation of Investment Opportunities

SEC Charges Hedge Fund Manager and Its Founder with Securities and Investment Adviser Fraud Based on "Cherry Picking" of Trades

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By Vincent Pitaro, *Hedge Fund Law Report*

The SEC has clearly communicated its commitment to scrutinizing how hedge fund managers are identifying and managing conflicts of interest specific to their businesses. See, e.g., "Davis Polk 'Hedge Funds in the Current Environment' Event Focuses on Establishing Registered Alternative Funds, Hedge Fund Manager M&A and SEC Examination Priorities," Hedge Fund Law Report, Vol. 5, No. 24 (Jun. 14, 2012). One of the conflicts most commonly cited by the SEC is the fair and equitable allocation of investment opportunities by a hedge fund manager among its clients and proprietary accounts. The SEC's concern with conflicts raised by allocations has been emphasized in speeches, letters and compliance outreach programs; and is evidenced by an enforcement action commenced on December 14 by the SEC against Peter J. Eichler, Jr. and his investment advisory and hedge fund management firm Aletheia Research and Management, Inc. (Aletheia). See also "SEC Charges Hedge Fund Adviser With 'Cherry Picking,'" Hedge Fund Law Report, Vol. 1, No. 22 (Oct. 10, 2008).

Overview of Allegations

The action generally alleges that from 2009 through 2011, the defendants committed securities fraud and numerous compliance violations by improperly allocating thousands of options trades made by Eichler. In particular, the SEC alleges that Eichler allocated trades among client and proprietary accounts long after those trades had been executed, and, in many cases, after he had already closed out the position. Armed with improved or even perfect knowledge, he disproportionately allocated winning trades (or trades with smaller losses) to his own personal accounts; Aletheia's house account; and the accounts of employees, relatives and favored clients. He disproportionately allocated losing trades to two hedge funds managed by Aletheia. In addition, the SEC charges that the defendants failed to advise Aletheia's clients of the firm's extremely precarious financial situation until literally the eve of its bankruptcy filing, even though the defendants had known of the gravity of the situation for at least several months. The SEC charges the defendants with violations of the anti-fraud provisions of the Securities Exchange Act of 1934 (Exchange Act) and the Investment Advisers Act of 1940 (Advisers Act) as well as numerous other violations of the Advisers Act.

Aletheia

Aletheia, a California corporation, has been a registered investment adviser since 1998. Eichler is the founder, majority owner, chief executive officer and chief investment officer of Aletheia. As such, he personally supervised and had full discretionary control over all Aletheia client accounts and trading activities. Aletheia, whose clients consisted mainly of institutional investors, foundations, endowments, pension funds and high net worth individuals, offered those clients various investment portfolios that followed different investment strategies.

In addition, and central to this case, Aletheia also managed (1) "custom accounts" for certain clients (Managed Accounts), (2) Eichler's and Aletheia's personal accounts and the accounts of Aletheia officers, employees and family members (together, Aletheia Accounts) and (3) two hedge funds, Aletheia Insider Index, L.P. and Aletheia Insider Index II, L.P. (together, Funds). The Funds, and several dozen of the Managed Accounts and Aletheia Accounts (together, Option Trading Accounts), traded in options during the period of Eichler's alleged cherry-picking scheme. Eichler, individually or through Aletheia, had control of such options trading and, critically, of the allocation of option trades among the various Option Trading Accounts.

The SEC's complaint implies that the Funds were severely affected by the 2008 financial crisis: At the end of 2008, before the cherry picking began, the Funds together had more than $111 million in net assets. By July 2012, their net assets had shrunk to less than $3 million, which the SEC attributes to investor redemptions and trading losses.

Aletheia has been on the SEC's radar for some time. In 2011, it settled an SEC administrative proceeding relating to its failure to disclose SEC deficiency letters to investors and prospective investors. See "Is a Hedge Fund Manager Required to Disclose the Existence or Substance of SEC Examination Deficiency Letters to Investors or Potential Investors?," Hedge Fund Law Report, Vol. 4, No. 18 (Jun. 1, 2011).

The Cherry-Picking Scheme

When an investment adviser manages a number of funds or accounts that follow similar strategies, or that can all invest in the same type of security, the adviser must allocate trades in a fair and equitable manner among those accounts. It can be challenging for advisers to implement and follow policies designed to assure that allocations are fair and equitable as well as consistent with the adviser's fiduciary duties owed to clients. See "How Can Hedge Fund Managers Avoid Criminal Securities Fraud Charges When Allocating Trades Among Multiple Funds and Accounts?," Hedge Fund Law Report, Vol. 4, No. 19 (Jun. 8, 2011). If it does not do so, an adviser may be accused of "cherry picking," which is a practice whereby an adviser allocates investment opportunities in a manner that disproportionately benefits accounts in which he or favored friends or clients have a proprietary interest.

The SEC alleges that Eichler's cherry-picking scheme took place from August 2009 through November 2011, during which time Eichler placed 4,791 option trades for the Option Trading Accounts "for an aggregate investment of $238.9 million." The crux of the complaint is that:

> The trades were not allocated to any account until after each trade was executed. Because the majority of those trades were allocated more than one hour after trade execution, or allocated after the options position had closed (when profit or loss on the trade was certain), Eichler was routinely able to cherry pick winners and losers

> for the benefit of the [favored Aletheia Accounts and Managed Accounts], and at the expense of the [Funds].

Eichler gave option trading orders to a trading assistant, who filled out a trading ticket with the security, quantity and, when directed by Eichler, a price limit for the trade. The account for which the trade was intended was left blank. The trades were placed with Aletheia's clearing broker, National Financial Services, LLC (NFS), either through an allocation account held by the Funds or a separate general allocation account held by an Aletheia affiliate. Eichler could move a trade from the Funds to the other Option Trading Accounts, and vice versa, by canceling the trade and re-placing it through the other account. Commencing in August 2010, Eichler placed all option trades only through the Aletheia affiliate's account, not through the Funds' account, which facilitated his cherry picking. At some point after the trade was executed, Eichler would tell the trading assistant the specific account to which the trade should be allocated. Only then did the assistant complete the trade ticket and allocate the trade in the NFS system.

Of the 4,791 option trades Eichler effected in the course of the scheme, 62% were allocated more than an hour after order execution, which greatly increased the odds of knowing whether the trade would be profitable or not. Of those trades, Eichler allocated 461 trades after the option position was already closed out, when he knew the actual profit or loss on the trade. Of the trades Eichler allocated to the Managed Accounts and Aletheia Accounts more than one hour after execution, more than half of those trades were profitable. In contrast, less than 38% of such trades allocated to the Funds were profitable. Of the 461 trades Eichler allocated with "perfect information," virtually all of such trades allocated to the Managed Accounts and Aletheia Accounts were profitable, while barely 32% of such trades allocated to the Funds were profitable.

The complaint contains several specific examples of Eichler's selective allocations, including four examples of Eichler allocating profitable closed out trades only to his personal accounts (or to both his personal account and that of his personal trader) and two instances where he allocated unprofitable closed out trades solely to the Funds. In another example, when allocating unprofitable open options in the same security that had been purchased at different prices, he allocated the options with higher cost (and, therefore, greater losses) to the Funds, while allocating those purchased at lower cost (with smaller losses) to the Managed Accounts and Aletheia Accounts. In an eighth example, he allocated an unprofitable open option trade solely to the Funds.

The trades that Eichler allocated within one hour turned out to be net losers across the board for all of the Option Trading Accounts. On the other hand, the Managed Accounts and Aletheia Accounts realized net positive returns ranging from 2.7% to 5.6% on trades allocated more than an hour after execution, while the Funds experienced losses of 6.5% on those trades. The Managed Accounts and Aletheia Accounts realized profits of from 11% to 19% on the perfect information trades while the Funds lost 1.7% on such trades. The SEC claims that, on the trades allocated more than one hour after execution, the Managed Accounts and Aletheia Accounts realized net profits of approximately $4.14 million, of which approximately $2 million was realized in Eichler's personal accounts, while the Funds experienced net losses of approximately $4.4 million.

The SEC notes that Eichler and Aletheia owed fiduciary duties to their advisory clients "to exercise the utmost good faith, to disclose all material facts, and to employ reasonable care to avoid misleading them." Their selective allocation of profitable trades to the Aletheia Accounts and Managed Accounts at the expense of the Funds, and their allocation of a disproportionate share of losing trades to the Funds constituted breaches of such duties. The defendants had no justification consistent with their fiduciary duties for allocating trades in that manner. Moreover, Eichler and Aletheia did not disclose their cherry-picking scheme to the Funds or to their advisory clients or the clear conflict of interest that late allocation of trades presented. The cherry-picking scheme was manipulative and deceptive and defrauded the Funds and their investors. Given that so many trades were allocated after they were closed out, "there is no doubt that the Defendants: knowingly or recklessly intended to deceive, manipulate or defraud" their advisory clients. In the alternative, the SEC alleges that Eichler and Aletheia were at least negligent in making the allocations.

Deficient Policies and Internal Controls

Aletheia had adopted a "Code of Conduct and Regulatory Compliance" (Code), which required employees to "'act with honesty, integrity' and 'in an ethical manner.'" It admonished employees to avoid conflicts of interest and never to take "an actual or apparent benefit over the account of any client." However, that Code was silent with respect to allocations of Eichler's option trading and did not require him to allocate those trades "at or near the time of trade execution." Finally, even if the Code had policies applicable to the type of trading at issue, the Code by its terms did not apply to trading in the Aletheia Accounts.

Failure to Disclose Its "Precarious Financial Condition" to Clients or in Form ADV

Aletheia had been in financial trouble for some time. From 2011 through September 2012, Aletheia's assets under management fell from $7.24 billion to approximately $1.44 billion. In two different 2010 lawsuits with certain minority shareholders, Aletheia claimed that the shareholders had caused Aletheia "to suffer great losses, including the loss of key employees as well as clients and investors." It claimed that the litigation "severely inhibited" its ability to operate profitably. Moreover, in July 2012, the State of California asserted a $2 million tax lien against Aletheia for unpaid 2008 taxes and demanded interest and penalties for late filing of subsequent returns. Then, on October 1, 2012, with the lien still unpaid, California suspended Aletheia's authority to conduct business. When it filed for bankruptcy on November 11, 2012, in addition to the California tax lien, Aletheia reported almost $10 million in other debts and had cash on hand of only around $300,000. Aletheia allegedly did not disclose any of these developments to its clients until November 9, 2012, just two days before it filed for bankruptcy protection.

In addition, the SEC notes that, in 2011, Form ADV was amended to require Aletheia to disclose to investors in plain English, in a narrative brochure, "any financial condition that is reasonably likely to impair Aletheia's ability to meet its contractual obligations to its clients." Nevertheless, the SEC claims that Aletheia failed to report the litigation, the tax lien or the potential suspension of business in conjunction with its September 14, 2012, Form ADV filing. Aletheia then waited more than one month to amend Form ADV to disclose California's suspension of its right to do business. That subsequent filing also neglected to disclose that Aletheia was behind in payments to business creditors. See "Is the New Form ADV Investor Friendly?," Hedge Fund Law Report, Vol. 5, No. 19 (May 10, 2012).

Specific Charges

The SEC complaint contains three separate fraud claims against both Eichler and Aletheia, and four other claims against Aletheia for Advisers Act compliance and reporting violations. The specific charges are:

- *Securities Fraud.* The SEC claims that Eichler and Aletheia engaged in fraud in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder through the cherry-picking scheme (First Claim).
- *Investment Adviser Fraud.* Both defendants allegedly violated the antifraud proscriptions set forth in Sections 206(1) and 206(2) of the Advisers Act by cherry-picking trades (Second Claim). In addition, the defendants' conduct also allegedly violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder with respect to Fund investors (Third Claim).
- *Compliance Violations.* Aletheia allegedly violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder when it "failed to adopt or implement policies and procedures reasonably designed to prevent the Defendants' cherry-picking scheme. . . ." (Fourth Claim).
- *Failure to Adopt a Code of Ethics.* Aletheia allegedly violated Section 204A of the Advisers Act, and Rule 204A-1(a) thereunder because it failed to adopt a code of ethics that requires "supervised persons to comply with applicable federal securities laws." (Fifth Claim).
- *Form ADV Violations.* Aletheia allegedly violated Section 207 of the Advisers Act by filing materially incomplete Forms ADV (Sixth Claim). Moreover, Aletheia violated Section 204 of the Advisers Act and Rule 204-1(a)(2) thereunder because it did not amend its Form ADV promptly to reflect either its precarious financial condition or California suspension of its authority to conduct business in that state (Seventh Claim).

The SEC complaint requests (1) a permanent injunction barring Eichler and Aletheia from future violations of those provisions; (2) an order directing each of them to "disgorge any and all ill-gotten gains obtained, and any and all losses avoided," as a result of the cherry-picking scheme or other misconduct, together with prejudgment interest; and (3) civil penalties.

For a copy of the SEC's Complaint, click here.