PART
ONE

Life, Death, and Degeneration

For decades, hedge funds have been the dream factories of finance where fortunes were made in mysterious ways, and occasionally lost. For those few who found hedge funds to be a school of hard knocks, it is probably apparent that the hedge fund life cycle can include a high "infant mortality rate," that hedge funds seem to die off in large numbers and, now and then, succumb to fraud.

Part One, Life, Death, and Degeneration, runs through three parallel strands of analytical development. Chapter 1 is an historical narrative of how laws continued, largely unsuccessfully, to grapple with the control of fraud. Chapter 2 looks at why current laws make it easier to discover—and bring to justice—perpetrators of fraud. Finally, Chapter 3, shows the unique structure of hedge funds how can contribute to the creation and continuation of fraud.

CHAPTER 1

Historic Roots of Prohibitions against Fraud

Hedge fund fraud is a conjunction of an ancient crime and a modern application. Fraud itself is a composite crime conjoining theft with deception. The earliest legal codes had clear proscriptions against theft ("thou shall not steal"), but a more ambiguous response to deception in general, focusing instead on false accusation ("thou shall not bear false witness").

FRAUD IN THE EARLIEST LEGAL SYSTEMS

In ancient history, laws that directly addressed commercial behavior tended to lag behind those that ensured the power of rulers. There are exceptions, however. The Code of Hammurabi and the Twelve Tables of the Roman Republic directly address fraud. The Code of Hammurabi dictated the death penalty for many crimes including theft and for "fraudulent sale of drink." The law 265 states that if "a herdsman, to whose care cattle or sheep have been entrusted, be guilty of fraud and make false returns of the natural increase, or sell them for money, then shall he be convicted and pay the owner ten times the loss." Romans were liable under the stricture of Tablet VIII, law 21, which stipulated that if "a patron shall defraud his client, he must be solemnly forfeited ('killed')."

However, despite the threatening tone of the early statutes, most were ineffective in their implementation and, until modern times, *caveat emptor* was the main defense against fraud. Most of the efforts to control fraud were applied to the sale of food in public markets, though here too the concern may have been more about preserving social order than protecting the rights of individuals. The regulation of food markets in post–Medieval England illustrates these early efforts. A number of specific selling practices were outlawed, with variable success. These included proscriptions against "forestalling," "regrating," and "engrossing," all of which concerned exploitative or deceptive practices by market sellers of food.

England's first chartered joint-stock company, the Muscovy Company, was founded in 1555, in part based upon the earlier model of medieval shipping joint ventures, which enabled the collective funding and sharing of risks. Over the next hundred years, the number and scope of these companies expanded rapidly—by 1696 there were over 150 traded—and with them, the scale and complexity of the market for shares and the emergence of brokers, jobbers, and dealers, and along

with them, the numbers and types of market abuse. One such early abuse was the "corner," where investors colluded in the use of options to gain effective control of the market for a particular security or commodity.

Another financial innovation that greatly expanded the scope of fraud was the creation of a market for government debt. In England, the first such issue was in 1693. The Bank of England was established the following year and it assumed the responsibility for funding the government by debt issues, further expanding the scope of the investing public.

Within a very few years of these new markets getting underway there was a growing chorus of opinion and ridicule calling for controls to be put in place to limit abuse. Bills were debated by Parliament in 1694 and 1696, and in 1697 a bill was passed to limit the number of brokers to 100 and requiring that they be licensed by London's Lord Mayor. The Lord Mayor took the initiative by putting in place a number of regulations for brokers to follow.

In 1720 the exponential growth in the value of the South Sea Company and its subsequent calamitous collapse ultimately caused a seismic shift in legislation and the regulation of markets culminating in the passage of the "Bubble Act" by Parliament, often referred to as the "first securities law." The act banned the sale of stock in unchartered companies and specified four forms of sanction: fines and other punishments related to public nuisance offenses, imprisonment, and forfeiture, the right of investors to sue for treble damages, and the loss of license for brokers who engaged in such sales. Unfortunately, the Bubble Act was little used in the following decades, with one case prosecuted in 1722 and the next not until 1808, despite the proliferation of unchartered companies.

The next big legal innovation in England was Barnard's Act, which sought to regulate widespread abuses caused by stockjobbers. This act restricted their activities in three areas: restricting the use of options, contracts for differences, and naked shorts. But Barnard's Act proved as ineffective in enforcement as the earlier Bubble Act.

The growth and sophistication of the U.S. economy progressed more or less in parallel with that of England and with it so did the financial innovations and attempts to control them. Actions to combat fraud in securities advanced on two fronts: in private actions under common law and in state and federal statutes. State courts recognized the right of private actions as early as 1790. A decision in Connecticut (*Bacon v. Sanford*) was based on a case where the buyer of a security sought damages against the seller who apparently knew the correct value but chose to deceive the buyer, who did not. Many such cases of intentional misrepresentation and false statements in selling followed. Some of these cases reached criminal courts.

Over the years leading up to the mid-nineteenth century, English and American courts extended the interpretation of misrepresentation in common law cases to include statements made by sellers in public documents (as opposed to specific documents given to the buyer). This gave buyers of securities the general form of redress against fraudulent sellers that exists in modern times.

Progress at the state and federal level continued in parallel. Massachusetts issued public debt bonds in 1751 and was soon copied by other states. The national government in the form of the Continental Congress issued its first debt bonds

in 1776. Patterns of trading closely followed English models as did market abuses. The onset of the Revolutionary War exacerbated the abuses and led to public calls to curb them. A number of speculators were arrested in Pennsylvania in 1779 for forestalling and engrossing.

Perhaps the earliest effort to regulate trading at the national level in the United States were provisions against insider trading that were included in the act that established the U.S. Treasury in 1789. This was the first statute to specifically address this crime in the United States or England and arose because of bad experiences with corruption and speculation in prior government debt issues, especially during the war period.

After a severe market crash in 1792 various states considered enacting versions of England's Barnard's Act, restricting stockjobbing. Pennsylvania tried to pass a weaker version, but even this failed; however New York later passed an act nearly identical to the failed Pennsylvania one. The statute was reenacted in 1801 and again in 1812. Some provisions were eased in a subsequent version, though a ban on selling shares that one did not own (short sales) remained until 1858 when the act was repealed.

Over the next few decades, the individual states legislatures and courts were active in efforts to rein in stock speculation. These efforts included acts to license stockbrokers, ban time trades, establish maximum settlement times, specify minimum holding periods for bank stocks, restricting banks from speculating in stocks, and applying ad hoc stipulations in the issuance of initial offerings.

In a then-famous 1862 case involving the Parker Vein Coal Company, officers of the company were found to have issued a $1.3 million tranche of fraudulent stock as part of a larger bona fide issue. This led the states of New York and Michigan to criminalize fraud in the issuance of securities. However, these findings only applied to misstatements and did not impose any obligations on issuers or sellers to make disclosures.

In 1882, New York State convened a special committee, the "Boyd Committee," to investigate the operation and use of stock market corners. "Do evils exist in the methods of the operators?" Chairman Boyd asked of a subpoenaed witness. "Not only do evils exist," the witness responded, "but they shall entail a public calamity." "Do you think it is the duty of the Legislature to remedy the evil?," the chairman asked another witness. "In every aspect of the case," he answered, "it is just as much the duty of the Legislature to remedy this evil as any other evil affecting the material and moral welfare of the people."[1]

The Boyd Committee concluded:

- A tax should be placed on futures trades where no physical delivery takes place.
- Futures sales for physical delivery are legitimate.
- Puts and calls and bucket shops are gambling and should be treated as such.

In 1887, the state of Illinois put into effect a law banning bucket shops. A similar New York state law followed two years later.

[1] *New York Times*, "The Speculative Curse," April 9, 1882, p. 7.

MODERN DEVELOPMENT OF SECURITIES FRAUD REGULATION AND ENFORCEMENT

With the arrival of the twentieth century, the evolution of securities fraud regulation and enforcement became more coherent and cohesive. The first 35 years of the new century swept the nation from a long history of fragmented efforts by different states to stamp out an array of ill-defined evils to a concentrated national program to establish a comprehensive regulatory infrastructure for securities. Progress during this period was driven by three stock market panics, in 1907, 1914, and 1929, and a progression of state and federal investigative commissions to determine the causes of each as well as attempts to rid society of the evils that undermined it and hampered the economy. By the beginning of the new century, the list of interrelated evils plaguing the markets included:

- Bucket shops
- Combinations
- Corners
- Gambling
- Short selling (without physical delivery)
- Speculation
- Stock gambling
- Stockjobbing
- Time trades
- Trusts

In tackling these evils, the United States had to find a way to overcome the jurisdictional duality embedded in its legal system, comprised as it was of states and a federal government. It was not entirely clear who bore the responsibility for crimes within the securities markets, though the states had possession of the physical exchanges and therefore had to control them, but with national industries and nationwide investment it was hard to see how some 40-odd states each with their own laws and many with their own exchanges could function as effective enforcement.

On top of this, there was the deep divide that exists to this day over the need to protect the public from all manner of theft and corruption versus the need to maintain free and open markets. Caught within these challenging and conflicting frames of reference the easiest solution was to do nothing, and that sufficed for most of the time, but the devastating drumbeats of crashing global markets and in the middle of this period the first war to be fought on a global scale kept up the pressure for action.

THE MONEY TRUST AND THE PANIC OF 1907

From the late 1880s, the myriad evils that were perceived to be plaguing the markets began to coalesce in the public's mind into a super evil called the "money trust." This was seen as a nexus of power and money under the control of a relatively small number of rich industrialists who, through "interlocking directorships," controlled most of American industry, finance, energy, and transportation. The Democratic

Party, under the leadership of William Jennings Bryan, took up the challenge of opposing the money trust and, along with it, the debasing of the currency that was the result of going off the gold standard. The Panic of 1907 seemed to confirm the public's and the politicians' anxiety.

A failed attempt to corner copper was blamed as the immediate cause. This resulted in a run on several banks that were thought to be involved and had the knock-on effect of contracting credit generally. New York's third largest trust bank, Knickerbocker Trust, failed at this time. New York City was only saved from defaulting on its debt by the personal intercession of J. P. Morgan in purchasing its bonds.

The following year (1908) then President Theodore Roosevelt called for action against the vices of the market:

> *There is no moral difference between gambling at cards or in lotteries or on the race track and gambling in the stock market. One method is just as pernicious to the body politic as the other in kind, and in degree the evil worked is far greater. (However) The great bulk of the business transacted on the exchanges is not only legitimate, but is necessary to the working of our modern industrial system and extreme care would have to be taken not to interfere with this business[.]*[2]

Roosevelt called for the Congress "to prevent at least the grosser forms of gambling in securities and commodities," such as making large sales of what men do not possess and 'cornering' the market.[3]

Roosevelt's plea went largely unanswered. However, in 1909, the governor of New York, the state in which the nation's largest stock exchange, the New York Stock Exchange (NYSE), established the Hughes Committee along the very lines called for by Roosevelt "in view of the evils incident to speculation and of the importance of sound business methods in connection with our vast transactions in securities and commodities[.]"[4] Speculation was defined as "forecasting changes of value and buying or selling in order to take advantage of them."[5] The Hughes Committee went on to examine many of the specific speculative practices observed at the NYSE, in particular those involving manipulation. Distinctions were made between some forms that were acceptable (e.g., in support of a new issue), and others that were not (e.g., pushing up prices in order to dump shares).

BLUE SKY LAWS

In March 1911, Kansas broke new ground with the enactment of its "Blue Sky" law designed to prevent the fraudulent sale of securities by making it a felony crime. It also clearly set some standards for corporate disclosure and required licensing of

[2] Steven Thel, "The Original Conception of 10(b) of the Securities Exchange Act, *Stanford Law Review* 42, no. 2 (January 1990): 396.
[3] Ibid., 397.
[4] Ibid
[5] Ibid.

brokers. (The text of these laws can be found at the Web site of the Kansas Office of the Securities Commissioner at www.securities.state.ks.us/edu/bluesky.html.)

Section XII

> *Any person who shall knowingly subscribe to or make or cause to be made any false statement or false entry in any book of such company, or make or publish any false statement of the financial condition of such company or the stocks, bonds or other securities by it offered for sale, shall be deemed guilty of felony; and upon conviction thereof shall be fined not less than two hundred dollars nor more than ten thousand dollars, and shall be imprisoned for not less than one year nor more than ten years in the state penitentiary.*

Section XIII

> *[A]ny agent who attempts to sell the stocks, bonds or other securities of a company that has not complied with the act, or any agent who attempts to sell stock or bonds without having received a license from the bank examiner, shall be fined not more than five hundred dollars or imprisoned in the county jail not more than ninety days, or both.*

Of more than 500 applications received for licensing as brokers, the state only approved 44. This act is credited with driving many corrupt operators out of the state. It is not surprising then that over the next several decades every state with the exception of Nevada passed a similar "blue sky" act. New York State passed its blue sky law in 1921, the Martin Act, which remains a formidable and still sharp weapon against fraud.

THE PUJO COMMISSION

In May 1912, a Senate Congressional subcommittee, the Pujo Committee, was formed to investigate the "money trust," blamed for the panic of 1907. As a secondary objective the Commission was also to investigate the control of the nation's stock exchanges. Much of the substantive debate picked up where the Hughes Commission had left off and frequent reference was made to its findings regarding the New York Exchange, speculation, and manipulation.

Many of the top industry and finance leaders of the day were called in to answer questions, including J. P. Morgan and John D. Rockefeller. Among other things, the Pujo Committee exposed the monopolistic practices of the "combines" and the web of interlocking directorates by which a few at the top could control the resources and workings of many companies across all of finance, industry, and transportation.

The findings led to proposals for amendments to the national banking laws and, more pertinent to the subject of this book, a bill that prohibited the use of interstate communications—mail, telegraph, and telephone—in the commission of a securities fraud. The interstate feature gave the federal government a basis for jurisdiction in

fraud cases, whereas the blue sky laws did the same for the individual states within their own boundaries.

Both the Hughes and Pujo committees were important and influential in defining and forming public attitudes to specific areas of market abuse however, little or no effective legislation was enacted between the time of the Pujo findings and the 1929 stock market crash. Nevertheless, one precedent-setting development that came out of the World War I years (1917–1919) was the Capital Issues Committee, a wartime agency that functioned for just six months, during which time it effectively regulated securities issuance and served as a model and precedent for the later Securities and Exchange Commission (SEC). Also during this period, a number of bills were debated in Congress, at least one of which, proposed by Congressman Dennison, helped to move the regulatory thinking forward, in this case with respect to linking the various state blue sky laws with a federal interstate commerce provision to create a seamless jurisdiction, though none of these were enacted.

Another landmark of this time was the appearance of the first mutual fund in 1924, the Massachusetts Investors Trust.

THE GREAT CRASH AND THE PECORA COMMITTEE

The Great Crash of 1929 was the defining event on the road to regulation. It significantly raised the temperature on legislators to get some effective laws enacted. Within the government there were two main pathways to accomplish this end: one was yet another committee to investigate and recommend and the other was the executive office itself, with the accession of Franklin Delano Roosevelt as the nation's president.

The Pecora Committee, empaneled in March 1932 by the Senate Banking and Currency Committee, initially at the behest of President Hoover, who believed manipulators were responsible for market declines. This committee followed a path similar to its 1912 predecessor, the Pujo Committee, calling in for public questioning the heads of the large banking houses, including Otto Kahn (Kuhn, Loeb), Charles Mitchell (National City Bank), and J. P. Morgan Jr. as well as the head of the New York Stock Exchange, Richard Whitney.

By January 1934, the Pecora Committee had reached the main recommendations it wished to incorporate into a bill comprising four main points:

1. Stock exchanges to be licensed by the federal government.
2. Establishment of an administrative authority to assure fair dealings.
3. Authorities given the powers to revoke an exchange license or impose other penalties.
4. Authorities also given discretionary powers over rules governing transactions that could take place within exchanges.

ROOSEVELT'S MEN

Before Franklin D. Roosevelt became the 32nd president, one had to go back to Woodrow Wilson to find a similar champion of financial reform. In 1911, as Governor of New Jersey, Wilson strongly came out against the "money trust," saying,

"The great monopoly in this country is the money monopoly. So long as that exists, our old variety and freedom and individual energy of development are out of the question." These words were quoted in an influential book, *Other People's Money* written by Justice Louis Brandeis, who, with Wilson, was very active in promoting and fostering new financial legislation and, along with the Pecora Commission, formed a conceptual foundation and reservoir of talent when Roosevelt took office in 1933. More than any chief executive before and since, with the possible exception of President Obama, Roosevelt injected himself directly into the process of crafting both the general objectives and specific words of the acts that would regulate the financial world for the next 75 years.

Before becoming president, Roosevelt had been governor of New York State (1929–1932), an office that put him in one of the best possible vantage points to observe the unfolding of the Great Crash of the stock market as well as the opportunity to know many of the people that would be instrumental in designing the new legislation that would be needed to fill the vacuum left in its wake. In addition to Samuel Untermyer, chief counsel to the Pecora Commission, the key talent enlisted by Roosevelt was Felix Frankfurter, a Harvard Law School professor and through him some of his most gifted students including James Landis, Benjamin Cohen, and Thomas Corcoran. Years later, Landis went on to become head of the U.S. Securities and Exchange Commission (SEC). All of these, now Roosevelt people, were lawyers who had cut their teeth in antitrust cases and were supporters of the work of the Pujo Committee.

THE SECURITIES ACT OF 1933

Roosevelt's "MO" in getting bills drafted was to secretly put several teams to work in parallel and then switch between them as the merits of each emerged in Congressional debate. He was like a single jockey riding three or four horses in a race, switching mounts as the race progressed, determined to be on the winner when it crossed the line.

In the final version of the Securities Act, the first of Roosevelt's securities bills, the final drafting team (Landis, Cohen, and Corcoran) chose the most recent revision of the English Companies Act (1908) as a model for their work. In particular, what became Schedule A of the Securities Act, detailing the content of any prospectus issued to the public, drew much of its form and content from this earlier English act.

In introducing his legislative proposals to Congress on March 29, 1933, Roosevelt stated "This proposal adds to the ancient rule of caveat emptor the further doctrine: 'Let the seller also beware.'" This statement clearly illustrated the new government thinking on market regulation—that issuer's would now bear a regulatory risk to offset some of the credit risks faced by the buyers.

The act's main weapon against securities fraud was enshrined in Section 17, Fraudulent Interstate Transactions, subsection (a), Use of interstate commerce for purpose of fraud or deceit:[6]

[6] *Securities Lawyer's Deskbook,* University of Cincinnati, College of Law, Securities Act of 1933, Section 17 (Interstate Commerce).

a. It shall be unlawful for any person in the sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

   1. to employ any device, scheme, or artifice to defraud, or
   2. to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
   3. to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Another section with teeth to fight fraud is Section 5(a) relating to the need to be registered to engage in interstate trading of securities[7]:

Section 5—Prohibitions Relating to Interstate Commerce and the Mails

a. Sale or delivery after sale of unregistered securities Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

   1. to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
   2. to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

At the time the Securities Act was enacted there was no SEC. Instead the provisions of the act were to be supervised by the Securities Department of the Federal Trade Commission (FTC). The shift to the new regulator would not take place until the following year.

THE SECURITIES AND EXCHANGE ACT 1934

The next important piece of legislation to be drafted was the Securities and Exchange Act of 1934. This act was initiated by yet another committee, this one established by then Assistant Secretary of Commerce John Dickinson in October 1933. Where the Securities Act addressed disclosure and issuance, the main focus of this committee was the regulation of the stock exchange and ultimately the creation of the Securities and Exchange Commission. A report was produced in January 1934. For the work on drafting the bill, Landis reunited with his two colleagues, Cohen and Corcoran. The bill was introduced to Congress as the Fletcher–Rayburn bill after its sponsors in the Senate and House, respectively and over the next few months, after much revision, "morphed" into the Exchange Act. One of the revisions was the creation of the new securities regulator, the Securities and Exchange Commission.

[7] *Securities Lawyer's Deskbook,* University of Cincinnati, College of Law, Securities Act of 1933, Section 5.

The new act, passed in May 1934, also contained new provisions to enforce antifraud measures, among them the combination of Section 10(b) and its companion Rule 10b-5, which together are, by far, the most frequently used antifraud weapon in the securities arsenal:

> Section 10—Manipulative and Deceptive Devices
>
> "It shall be 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 of any national securities exchange—
>
> To use or employ, in connection with the purchase on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."
>
> Rule 10b-5— Employment of Manipulative and Deceptive Devices
>
> It shall be 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 of any national securities exchange,
>
> a. To employ any device, scheme, or artifice to defraud,
> b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> c. 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 reason for the peculiar duplication of content in 10(b) and Rule 10b-5 reflects Congress' view that it could not, or should not, determine the fact of securities fraud, but should delegate that responsibility to the SEC.

THE INVESTMENT ADVISER'S AND INVESTMENT COMPANIES ACTS OF 1940

With all of the Congressional committee investigative work of the early 1930s, resulting in the passage of significant legislation such as the Securities Act (1933) and Securities Exchange Act (1934) and others such as the Public Utility Holding Company Act (1935), the regulation of the principal financial participants had been determined. So, from the middle of the decade committee research turned to the roles of several of the remaining participants, including investment companies and investment advisers.

It is thought that the first dedicated investment advisory firm, A. M. Clifford, commenced operations around 1915. Having started in 1911 as a broker, the company decided to specialize in order to manage the assets of one of its clients. From that time, Clifford referred to itself as an "investment Counselor and Financial Analyst." Scudder Stevens & Clark started up in 1919 with the sole purpose of selling investment advice for a fee for the amount of assets under management. By

1934, when legislation was being debated, the number of investment counselors had grown to 394. At that time most states required no registration or professional competency standards for these firms. The provisions in the act were derived largely from consultations with industry. The act became effective in November 1940.

The two sections of this act most cited in the hedge fund fraud cases in this book are 206(1) and 206(2), below[8]:

> Section 206—Prohibited Transactions by Investment Advisers
>
> It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> 1. to employ any device, scheme, or artifice to defraud any client or prospective client;
> 2. to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

COMMODITIES REGULATION

The first known commodities trading market was established in Osaka, Japan, in 1650. The first commodity exchange in Chicago, the Chicago Board of Trade (CBOT), started trading in 1848, some 56 years after the Buttonwood Agreement that served an equivalent purpose for stock trading in New York.[9] Another Chicago exchange, the Produce Exchange, opened for trade in 1874. And where the CBOT concentrated on grain, the produce exchange traded produce, eggs, lumber, and livestock. In 1898, a group representing the Produce Exchange Butter and Egg Board split away from the Produce Exchange.

As early as 1858, the CBOT issued guidelines for grain quality, and in the following year the exchange received a charter from the State of Illinois, giving it the power of law. The CBOT followed with a ban on options trading in 1865 and the setting of regular hours of trade in 1873.

The Civil War years (1861–1865) were generally prosperous for grain traders and, while the exchange appreciated the role of speculation in fostering liquidity, the markets were frequently plagued by cornering operations, resulting in what turned out to be only a one-year ban on short selling in 1866. As with the equities markets in New York and other cities, Chicago was also besieged by bucket shops. A *Chicago Daily Tribune* article in 1879 expressed the frustrations of the time: "The fraud, cheat and swindle are so transparent that it seems to be a libel on common intelligence to admit that these establishments do an immense business every day."[10]

The exchange made strenuous efforts to stamp out the bucket shops by disconnecting the Western Union telegraph lines that they used to receive prices and at one time whited-out the windows of the exchange to stop information getting out.

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[8] *Securities Lawyer's Deskbook,* University of Cincinnati, College of Law, Investment Advisers Act 1940.

[9] David Greising and Laurie Morse, *Brokers, Bagmen, and Moles: Fraud and Corruption in the Chicago Futures Markets* (New York: John Wiley & Sons, 1991), 41, 45.

[10] Ibid., 48.

In a 1904 U.S. Supreme Court case against the bucket shops, the exchange won the right to control the flow of its information and, in the Chief Justice's opinion also legitimized options trading. In 1919, the Chicago Mercantile Exchange opened its doors, offering futures and forward contracts in butter and eggs only. Cheese was added in 1929 and potatoes in 1931.

The Federal Trade Commission, which at that time had responsibility for oversight of the exchanges carried out an extensive study of grain trading, including grain futures. In August 1921, the Future Trading Act was passed which regulated trading in grain. This act incorporated the unusual feature of a 20-cents-a-bushel punitive tax on options and futures trades not executed on a designated market contract. However, the following year the U.S. Supreme Court in *Hill v. Wallace* declared the Future Trading Act to be unconstitutional because of its use of Congress' taxing powers.

In September 1922, the Grain Futures Act became law. Unlike its predecessor, the Future Trading Act, the new bill utilized interstate commerce as the basis for the government's jurisdiction (rather than tax). The act prohibits trading outside of the market contracts. It also called for the establishment of a Grain Futures Commission as an agency under the Department of Agriculture. Another Supreme Court Case (*Board of Trade v. Olsen*) in February 1923 upheld the constitutionality of the new act.

THE COMMODITIES EXCHANGE ACT OF 1936

On June 15, 1936, the Grain Futures Act was superseded by the Commodity Exchange Act. The new act expanded the number of commodities traded to include: cotton, rice, mill feeds, butter, eggs, Irish potatoes, and grain. In a similar vein, the Grain Futures Commission was superseded by the Commodity Futures Commission. From time-to-time over the coming years, several commodities were added to the list of those traded and several were also dropped.

Within the new legislation the most oft-cited section in the hedge fund fraud cases is Section 6(b) Fraud, false reporting, or deception prohibited:

> U.S. Code: Title 7 (Agriculture),
>
> Chapter 1 (Commodity Exchanges)
>
> Section 6b Fraud, false reporting, or deception prohibited
>
> (a) "Contracts designed to defraud or mislead; bucketing orders
>
> It shall be unlawful
>
> (i) to cheat or defraud or attempt to cheat or defraud such other person;
>
> (ii) willfully to make or cause to be made to such other person any false report or statement thereof, or willfully to enter or cause to be entered for such person any false

The Commodity Futures Commission was overhauled once again with its powers expanded in 1974 and renamed as the Commodity Futures Trading Commission (CFTC) as it stands today. In September 1975, the reformed CFTC approved the first futures contract based on a financial instrument— "Ginnie Mae" certificates

futures. And in November the CFTC approved the first futures contract linked to U.S. government debt.

The CFTC rules were amended again in January 1979 to address the operation of commodity pool operators (CPO) and commodity trading advisers (CTA). This is the area that directly governs the equivalent of hedge fund managers/advisers within the commodities sphere.

BRIEF HISTORY OF FRAUD IN THE DIFFERENT TYPES OF INVESTMENT COMPANY

Like the big market crashes, the big investment frauds have had a permanent fascination for the public who never seem to tire of hearing of them: the Tulipmania, the South Sea Bubble, Credit Mobilier, the Mississippi Company …. But just below the scale of these national obsessions are hundreds of serious investment frauds that are more circumscribed in scope, generally involving fewer victims (even though these can number in the thousands) or having a shorter life in the press.

INVESTMENT TRUSTS

According to some industry claims, the first investment trust was the Foreign & Colonial Investment Trust, established in 1868, by the eponymous Foreign & Colonial Company. While this may have been the first such fund in the English-speaking world, it appears that earlier examples can be found in the Netherlands (including one created by King William I in 1822), at least as far back as 1774, credited to a merchant named Adriaan van Ketwich. There was apparently also an investment trust established in Switzerland in 1849. The first of these funds in the United States was possibly the American Investment Trust Co. noted in 1885, followed by others including the Boston Personal Property Trust, which was founded in 1893 and was also the first closed-end fund in the United States.

Perhaps the first (English language) evidence of fraud involving an investment trust was the case of the Land Investment Trust, part of the greater failure of the London and General Bank in 1892. This famous case occurred some 24 years after the founding of the Foreign & Colonial Investment Trust. Ultimately, a former Member of Parliament, Jabez Balfour, and several others were found guilty of the fraud and committed to prison.

MUTUAL FUNDS

In the case of the mutual fund, the generally acknowledged "first" in the United States was the Massachusetts Investors' Trust in 1924 (though the Alexander Fund in Philadelphia, founded in 1907 is an earlier prototype); however, the greatest growth came after the Funds Act of 1936, which granted "mutuals" exemption from corporate tax. Evidence for a "first" mutual fund fraud may not be extant until the early 1960s, when investors filed suits against several funds alleging unreasonable levels of fee payment to advisers, with the implication that fraud was involved.

This case bears similarities to the "market timing" cases of 2003 in that the suits were directed at a relatively broad industry practice rather than specific individual culprits and resulted in changes in industry practice (and in this case in new legislation).

A more clear-cut case of outright mutual fund-related fraud may be as late as 1973 (49 years after the appearance of the first U.S. mutual) in the case against Robert Vesco (who ended up controlling the sprawling and corrupt IOS funds empire discussed in the final section, "Funds of Funds"). Certainly by the early 1980s, there are records showing the SEC taking action against mutual funds. The first of these was the suspension of investment adviser Richard Bartoli for self-dealing and misconduct and, in February 1983, its revocation of the registration of Investment Adviser CMC Funding Ltd for fraud.

Using any of the preceding examples as a baseline, it appears that there was a lag of around 40 to 50 years between the emergence of mutual funds and the emergence of a recorded case of mutual fund fraud.

INDEX FUNDS

Index funds have exhibited a more peculiar pattern. The earliest index fund is thought to have been developed and managed by Wells Fargo, apparently for a single client pension fund (Samsonite Corp.) around 1971. The first multiclient index fund was probably launched in 1974 by Batterymarch Financial Management. Oddly, there is a record of an Index Fund, Inc.—a registered open-ended investment company that was a plaintiff in a civil bribery and stock manipulation case in which federal indictments were handed down as early as August 1972 (see Case 4). Among the defendants in the case, which commenced around June 13, 1973, was Robert Hagopian, president of the Index Fund and president and chairman of that fund's investment adviser.

The odd thing about this case is the fact that the dates ascribed to these actions (i.e., 1972 and 1973) would make this obscure fund among the earliest index funds created (believed to include Wells Fargo, American National Bank of Chicago, and Batterymarch Financial Management). Another curious conjunction is the fact that this fund was a Boston-based company, as was Batterymarch Financial Management, whose principals, Jeremy Grantham and Dean LeBaron, created the first multiclient commercial index fund in Boston between 1972–1974. Mr. Grantham had put the concept in the public domain by speaking of it at a seminar at the Harvard Business School in 1971. If the Index Fund, Inc., was a genuine fund, it would suggest that its president, Robert Hagopian, probably had some contact with Grantham and LeBaron, perhaps even having attended the seminar chaired by Grantham at Harvard.

Apart from the above legal footprints, the only other known case involving an index fund to date occurred in November 2001, at which time criminal charges and later civil charges were brought against a Steven Adler, who was the principal of a company called Vector Index Advisors. In fact, this company did not manage any index funds, but had a two-stage strategy fraudulently deployed, in which a tactical switching between the one strategy and the other was based on whether the equity index was rising or falling. This manager was ultimately jailed for 60 months and his company was deregistered by the SEC.

Other than these two cases—one puzzling due to its extremely early date, the other with only the most tangential relationship to an index fund—there have been no other cases of index fund fraud to this day. One potential explanation for the scarcity of index fund frauds is simply due to the fact that there were never very many index funds until recently. A count of current index funds, however, seems to dispel this argument. At present there appears to be more than 2,500 funds, and over 300 fund groups (or management companies). So perhaps the answer has something to do with the nature of index funds; in particular, their objectively determined performance and the limited number of methods of achieving it. There have been articles from time to time criticizing index funds for practices the writer's have claimed or implied are exploitative, unprofessional, or dishonest, but the same could be said for other forms of investment, and such criticisms are not the same as there being grounds for pursuing a legal case.

FUND OF FUNDS

The fund-of-funds product either was or was not invented by Bernie Cornfeld. In 1962, his offshore mutual fund management company, IOS, launched the Fund of Funds, which would go on to become his most successful fund. Certainly he pioneered the general concept and was responsible for lodging that concept into the minds of investors worldwide. Unfortunately, for all concerned, IOS was a thoroughly corrupt organization and this first "fund of funds," if not wholly corrupt from the start, became substantially so as time went on. So, whether the Cornfield product can justifiably be called the first fund of funds is debatable. The later honest funds would understandably claim that it was not, that the IOS Fund of Funds was something different than today's fund of funds.

On the assumption that Bernie Cornfeld did not create the fund of funds product in 1962, then the credit for the launch of the first fund of funds should go to the March 29, 1985, inception of the Vanguard Star Fund. In Europe, a clutch of funds were launched in October 1985 when the United Kingdom's Department of Industry approved the product, including Abbey Life, Britannia, Grieveson Grant, Henderson, and, Save And Prosper.

The earliest example of wrong doing at the fund of funds dates to September 2002, with the case of Nathan Chapman Jr.'s Domestic Emerging Market Minority Equity Trust's fraud against the State of Maryland pension system. Also convicted and sent to prison in this case was Alan Bond of Albriond Capital Management. The apparent time interval between the launch of the fund of funds in 1985 and the presumed first fraud was 17 years.

HEDGE FUNDS

According to available facts and industry folklore, the first hedge fund was created in 1949 by Alfred Jones. The earliest fraud in relation to a hedge fund was in August 1968. This case accused the senior executives and salesmen of the then, Merrill Lynch, Pierce, Fenner and Smith, with providing insider information to several of its investment clients. These included five hedge funds. The hedge funds named were

among the earliest hedge funds, one of which was none other than A.W. Jones & Co. (and A.W. Jones Associates), the very first hedge fund (see Case 1 in the next chapter).

Assuming no earlier cases are found, it would mean that 19 years elapsed before a hedge fund fraud case had materialized. See Table 1.1 for a summary of years of the first known frauds and intervals.

TABLE 1.1 Financial Product Appearance and First Known Fraud

	A: 1st Known Example	B: 1st Known Fraud	Interval (B-A)
Investment Trusts	1868	1892	24
Mutual Funds	1924	1973	49
Index Funds	1971	1973	2
Fund of Funds	1985	2002	17
Hedge Funds	1949	1968	19