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A legal update from Dechert's White Collar and Securities Litigation and Financial Services Groups

Hedge Fund Manager Sentenced to Prison Term for Manipulating Stock Prices

A federal judge has sentenced an unregistered hedge fund manager to three years in prison and three years of supervised release for willfully defrauding clients.¹

According to an Information ("Information") filed in the federal District Court for the District of Connecticut by the office of Kevin J. O'Connor, United States Attorney for that District, and court filings in related civil cases,² Sacane engaged in a scheme between November 2002 and July 2003 to conceal regular and substantial purchases of stock in two thinly-traded biotechnology companies. These concealed purchases created a false appearance of demand that significantly increased the price of the companies' stock, large amounts of which had been accumulated by Sacane's clients. To conceal the scheme, Sacane failed to file required reports with the Securities and Exchange Commission (the "SEC" or "Commission") and made affirmative misrepresentations to the SEC, the management of the biotechnology companies, and a third-party fund manager. As a result of Sacane's scheme, Sacane was overpaid \$40 million in management and incentive fees, and when the scheme was revealed, the stock price of the two biotechnology companies fell by 43% and 23.5%, resulting in respective lost market capitalization of \$193 million and \$137 million.

Any willful violation of the Advisers Act may be penalized by up to five years in prison.³ Courts have traditionally imposed prison terms in cases in which an investment adviser directly embezzles the clients' assets, rather than in cases such as *Sacane* in which the investment adviser manipulates the funds' asset value to benefit from artificially high management and incentive fees. However, it is not unprecedented for an investment adviser to be imprisoned for falsely reporting net asset value, or for providing a false appearance of good performance.⁴

Sacane's prison sentence provides a powerful reminder that unregistered hedge fund managers are not immune from the anti-fraud provisions of the Advisers Act and the severe penalties that flow therefrom.⁵ The case also demonstrates that the criminal authorities have become increasingly aggressive in prosecuting violations by hedge fund managers. When Sacane was sentenced on January 30, 2007, Mr. O'Connor characterized the sentence as a warning to the hedge fund industry,

¹ *United States v. Sacane*, No. 3:05-cr-00325-AHN-1 (D. Conn., filed Dec. 21, 2005).

² In addition to the criminal case, Sacane was the subject of civil proceedings brought by the Securities and Exchange Commission and Federal Trade Commission. These actions are discussed further below.

³ 15 U.S.C. § 80b-17 (2006) ("Any person who willfully violates any provision of [the Advisers Act], or any rule, regulation, or order promulgated by the Commission under authority thereof, shall, upon conviction, be . . . imprisoned for not more than five years").

⁴ See e.g., *United States v. Strafaci*, 03 Crim 1182 (S.D.N.Y., filed Oct. 29, 2003) (sentencing a hedge fund manager to six years in prison for fraudulently overstating the net asset value of his client funds).

⁵ Section 206 of the Advisers Act applies, by its terms, to all investment advisers, as defined by Section 202(a)(11) of the Act, regardless of registration status.

stating: “[t]he prosecution and term of imprisonment should *send a strong message to hedge fund managers.*”⁶

Relevant Background⁷

Sacane was the founder, majority owner, and managing member of two investment adviser companies: Durus Capital Management, LLC and Durus Capital Management (N.A.), LLC (collectively, the “Durus Advisers”). Sacane and the Durus Advisers, none of whom were required to register with the SEC, advised a hedge fund called the “Durus Life Sciences Master Fund Ltd.” (the “Master Fund”), which was fed by both a domestic and an offshore feeder fund, and the “Artal Long Biotech Portfolio Fund, LLC” (the “Artal Fund”) (collectively, the “Durus Funds”). The Durus Funds paid the Durus Advisers a monthly management fee equal to 0.125% of the funds’ net asset value and a quarterly incentive fee equal to 20% of the profits generated in the prior quarter.

Following losses in the Master Fund of approximately 3.4% in 2002, Sacane began accumulating stock of two biotechnology companies, Aksys Ltd. (“Aksys”) and Esperion Therapeutics, Inc. (“Esperion”), purchasing substantial amounts of stock on a weekly basis between November 2002 and July 2003. Sacane’s trading in Aksys and Esperion stock during this period constituted an average of 40% of the total trading volume in Aksys and 25% of the total trading volume in Esperion. These substantial and systematic trades caused Aksys’ stock price to quadruple from \$3.65 per share to \$15 per share, and Esperion’s stock price to more than triple from \$5.65 per share to \$20 per share during the period.

Despite owning at times over 78% of Aksys’ outstanding shares and 33% of Esperion’s shares, Sacane concealed the Durus Funds’ positions in the two companies by:

- failing to file reports with the SEC as required when the Durus Advisers exceeded certain beneficial-ownership thresholds;
- underreporting the amount of stock beneficially owned by the Durus Advisers in reports that were filed with the Commission;
- making affirmative misrepresentations to the management of Aksys and Esperion to prevent them from triggering shareholders’ rights plans that would have diluted the Durus Funds’ ownership of the companies; and
- making affirmative misrepresentations to a third-party fund manager to prevent it from selling its holdings in the two companies. In addition, Sacane failed to file required notifications with the federal antitrust authorities which were required when the Durus Funds acquired a certain percentage or value of the companies’ voting shares.

Sacane’s scheme was exposed in July 2003, at which time Sacane’s prime broker threatened to report Sacane’s true positions in the companies to the SEC, Aksys, and Esperion, if Sacane did not do so himself. At this point, Sacane attempted to characterize his scheme as an inadvertent error caused by a standing-order buying program that erroneously continued to make trades despite Sacane’s instructions to discontinue the program. Sacane also tried to cover up his active involvement in the scheme by asking a trader to lie about the fact that Sacane received daily spreadsheets showing the number of shares that the Durus Advisers owned of each stock in its portfolio. Sacane also asked the trader to state falsely that he placed trades through Sacane’s computer and username, when in fact Sacane had made those trades himself.

On December 21, 2005, the United States Attorney’s Office for the District of Connecticut filed an Information in the District Court, charging Sacane with one-count of willfully violating Section 206 of the Advisers Act. Sacane plead guilty to the charge the same day. The information did not specify which subsection of Section 206 was violated, but the elements of the offense as outlined in Sacane’s plea agreement correspond with Section 206(2). Section 206(2) prohibits investment advisers from using the mails or any means or instrumentality of interstate commerce to

⁶ Press Release, United States Attorney’s Office for the District of Connecticut, Hedge Fund Manager Sentenced to Three Years in Federal Prison for Stock Market Manipulation (Jan. 30, 2007) available at <http://newhaven.fbi.gov/dojpressrel/2007/nh013007a.htm>.

⁷ These details are taken mostly from allegations in the SEC complaint that was filed in *SEC v. Sacane*, Civ. Action No. 3:05-cv-1575-SRU (D. Conn., filed Oct. 12, 2005).

directly or indirectly engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.⁸

Section 206 applies to all investment advisers as defined under Section 202(a)(11) of the Advisers Act. The Section applies to hedge fund managers irrespective of whether the hedge fund manager is exempt from registration with the Commission.⁹

Willful violations of Section 206 or any other section of the Advisers Act carry maximum penalties of five years imprisonment and \$10,000 in fines per violation.¹⁰ Under the alternative-minimum-fine provision of the United States Code, however, an offense that results in a pecuniary gain to the defendant or pecuniary loss to a person other than the defendant can be punished by up to twice the gross gain or loss.¹¹ Additionally, in some cases, the courts may order the defendant to provide restitution to the victims of a fraudulent scheme.¹²

As a result of Sacane's plea agreement, the United States recommended that the district court reduce by two levels Sacane's adjusted offense level under the United States Sentencing Guidelines. The government also filed a request for restitution, noting that while Sacane returned much of the \$40 million in artificial incentive fees to the Durus Funds' investors, he withheld approximately \$6 million in a trust, and that the Durus Funds were forced to pay \$28 million to settle claims brought by Aksys against the funds as a result of Sacane's misconduct.

On January 30, 2007, a United States District Judge sentenced Sacane to three years in federal prison,

⁸ 15 U.S.C. § 80b-6(2) (2006).

⁹ See *Goldstein v. SEC*, 451 F.3d 873, 876 (D.C. Cir. 2006) (noting that hedge fund advisers are subject to the anti-fraud provisions of the Advisers Act but may be exempt from the registration provisions); 15 U.S.C. § 80b-3(b)(3) (2006) (exempting from registration, any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under the Advisers Act).

¹⁰ 15 U.S.C. § 80b-17 (2006).

¹¹ 18 U.S.C. § 3471(d) (2006).

¹² See 18 U.S.C. §§ 3663, 3663A (2006).

followed by three years of supervised release, and scheduled a hearing on restitution for April 4–5, 2007.

Other Enforcement Actions Against Sacane

Sacane has been subject to not only criminal prosecution, but also to enforcement action by the SEC and the Federal Trade Commission ("FTC").

Prior to Sacane's criminal trial, the SEC filed a civil complaint in the District of Connecticut on October 12, 2005, also alleging that Sacane violated Section 206 of the Advisers Act, but additionally alleging that Sacane violated a number of other securities laws.¹³ Among the laws allegedly violated by Sacane are the anti-fraud provisions of other securities acts, including the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act") as well as various beneficial ownership reporting provisions of the Exchange Act.¹⁴ The SEC also alleged that Sacane made illegal short-sales in violation of the Exchange Act.¹⁵

The SEC is seeking permanent injunctions, disgorgement, and civil fines in the District of Connecticut. Although these claims are still pending, the SEC has already obtained an administrative order¹⁶ barring Sacane from association with any investment adviser

¹³ *SEC v. Sacane*, Civ. Action No. 3:05-cv-1575-SRU (D. Conn., filed Oct. 12, 2005); *In the Matter of Sacane*, Admin Proc. No. 3-12176, Advisers Act Release No. 2483 (Feb. 7, 2006).

¹⁴ According to the SEC complaint, Sacane violated these reporting provisions by: failing to file Schedule 13D or 13Gs as required when Sacane became the beneficial owner of more than 5% of Aksys and Esperion shares; significantly underreporting the shares of Aksys and Esperion over which Sacane had investment discretion in the Form 13Fs that Sacane did file with the Commission; failing to file Form 3s as required when Sacane obtained more than 10% beneficial ownership in Aksys and Esperion; and failing to thereafter file Form 4s to disclose changes in Sacane's beneficial ownership of the two companies.

¹⁵ Under Section 16(c) beneficial owners of more than 10% of a class of security must deliver the stock within twenty days after a sale of the stock. Sacane allegedly violated this provision by short-selling Aksys and Esperion stock in March and July 2003.

¹⁶ *In the Matter of Sacane*, Admin Proc. No. 3-12176, Advisers Act Release No. 2483 (Feb. 7, 2006).

pursuant to the SEC's powers under Section 203(f) of the Advisers Act.¹⁷

Sacane's scheme to purchase large quantities of Ak-sys and Esperion stock also drew the attention of the FTC, which filed a civil complaint in the District of Columbia on September 26, 2005, alleging that Sacane violated provisions of the Hart-Scott-Rodino Act (the "HSR Act").¹⁸ The HSR Act requires persons to observe a waiting period and notify the federal antitrust agencies before consummating certain acquisitions of voting securities in a corporation.¹⁹ Sacane settled with the FTC, agreeing to pay a \$350,000 civil penalty.

Because the HSR Act's notification and waiting-period requirements are primarily meant to allow the government sufficient time to analyze the antitrust implications of an acquisition on the *consumers* of a company's products as opposed to *investors* in the company, the enforcement action brought against Sacane by the FTC likely came as a surprise to many in the hedge fund industry. Notwithstanding the lack of precedent for this enforcement action, the FTC took the position that Sacane was "an experienced fund manager who should have known and fulfilled his obligations under the HSR Act."²⁰ The FTC also characterized Sacane's \$350,000 fine as a warning to other hedge fund managers, stating, "This significant penalty should put hedge funds, their managers, and securities traders on notice that they are not exempt from filing pre-merger notification forms when required to do so."²¹

Recent Trends in Enforcement

At first glance, the Sacane prison sentence may seem to be an outlier. One could view the sentence as

unique given the multiple violations and aggravating factors in the case. For example, not only did Sacane defraud his clients to obtain unearned management and performance fees, but he also willfully falsified reports filed with the SEC, and he manipulated the stock price of two operating companies, damaging their market capitalization and causing large losses to non-client investors.

It is likely, however, that Sacane's sentence is not merely a product of its facts but was also influenced by two recent trends in the enforcement of investment adviser fraud:

- the increased competency and willingness of U.S. Attorneys to prosecute securities cases, and
- the increased focus of enforcement authorities on hedge fund fraud.

As noted above, the U.S. Attorney prosecuting the Sacane case characterized the prosecution as a warning to hedge fund advisers that the federal government was actively looking for violations. Consistent with this warning, only two days after Sacane was sentenced, a hedge fund manager was indicted in the Southern District of New York for a scheme nearly identical to the one employed by Sacane.²² Another set of hedge fund managers were indicted in the Eastern District of Pennsylvania in October 2006 on charges that they falsely reported positive performance when the fund was losing money,²³ and U.S. Attorneys have also indicted or obtained convictions of hedge fund managers for more traditional embezzlement schemes in recent months.²⁴

The Sacane indictment is a chilling warning that enforcement authorities are applying greater scrutiny to

¹⁷ 15 U.S.C. § 80b-3(f) (2006).

¹⁸ *United States v. Sacane*, No. 1:05CV01897 (D.D.C., filed Sept. 26, 2005)

¹⁹ See 15 U.S.C. § 18a. (2006).

²⁰ Press Release, Federal Trade Commission, FTC Cites Hedge Fund Manager for Acquiring Stock Shares Without Gaining Premerger Clearance (Sept. 26, 2005), available at <http://www.ftc.gov/opa/2005/09/durus.htm>.

²¹ *Id.* (quoting Susan Creighton, Director of the FTC's Bureau of Competition).

²² See Press Release, United States Attorney's Office for the Southern District of New York, Hedge Fund Manager Charged in Securities Fraud Scheme Resulting in Investor Losses of \$88 Million (Feb. 1, 2007), available at <http://www.usdoj.gov/usao/nys/pressreleases/February07/whittierindictmentpr.pdf>.

²³ See Press Release, United States Attorney's Office for the Eastern District of Pennsylvania, Stock Brokers Charged with Fraud, Defendants Allegedly Misled Clients About Performance – Victims Lost Almost \$2 Million On Hedge Fund (Oct. 12, 2006) available at <http://philadelphia.fbi.gov/doj/pressrel/2006/ph101206.htm>.

hedge fund managers, that hedge fund managers are not exempt from the anti-fraud provisions of securities laws, and that each and any willful violation of those provisions can result in criminal liability.



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