Wielding Broader Powers, S.E.C. Examines Hedge Funds in London

By Anita Raghavan
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The financial district of Canary Wharf in London.
Credit Tal Cohen/European Pressphoto Agency

Updated, 8:07 p.m. | The Securities and Exchange Commission, which has actively pursued actions by American banks and other financial institutions overseas, is broadening its reach by asserting its purview to foreign hedge fund managers.

Agency employees are set to fan out across upscale Mayfair, home to some of London's biggest hedge funds, this week, paying visits to more than a dozen hedge fund managers registered with the S.E.C. to determine whether they are in compliance with American regulations.

The move reflects the S.E.C.'s new powers since the financial crisis, particularly under the Dodd-Frank Act of 2010, which was aimed at ferreting out wrongdoing and more tightly regulating private asset managers like hedge funds.

"The reason you are seeing these examinations happening now is that we are a few years past the Dodd-Frank Act, which in certain circumstances required overseas managers to register with the S.E.C.," said Robert Mirsky, partner and global head of hedge funds at KPMG in London. "With registration comes inspection by the S.E.C."

Since taking the helm this year, the agency's chairwoman, Mary Jo White, has sought to remake the S.E.C., which had been criticized for missing major scandals like the Ponzi scheme orchestrated by Bernard L. Madoff. In recent years, some of the S.E.C.'s most prominent cases have involved overseas operations of institutions based in the United States. For instance, S.E.C. enforcers investigated JPMorgan Chase over $6 billion in trading losses at its London operations, and its anti-bribery unit examined the bank’s hiring in Asia of children of Chinese officials.

Mary Jo White, chairwoman of the Securities and Exchange Commission, is expanding its influence to hedge funds in Britain.
Credit Chip Somodevilla/Getty Images

The new scrutiny of hedge funds in London, however, is causing consternation among local money managers. Several managers privately expressed concerns that the visits would lead to the importation of American-style regulation to British hedge funds that have American clients.

One British hedge fund manager is said to be considering closing his firm’s so-called European event-driven trading business — when a fund seeks to capitalize on a market-moving piece of news like an announced merger — in a bid to avoid being caught up in a stepped-up regulatory sweep.

Legal experts say the new inspections could pave the way for more oversight of the lightly regulated hedge fund industry.

“We are putting in place a structure for regulators around the world to reach across borders and get information,” said Leonard Ng, a partner at the law firm Sidley Austin in London. “I think the end result will be that regulators will be in possession of much more information than before, which will then give them an incentive to put the information to use either by drafting new regulations or taking enforcement actions to correct the deficiencies.”

Britain, where investment advisers manage 59 hedge funds with at least $500 million in assets, is the biggest hub of hedge fund managers after the United States, where 735 such funds are run, according to an S.E.C. report presented to Congress this year.

The S.E.C. has also teamed up with the Financial Conduct Authority, Britain’s chief financial regulator, to cooperate in overseeing the cross-border operations and activities of managers of alternative investment funds, like hedge funds.

Until a few years ago, hedge fund managers gave little thought to what were routine inspections. Before Dodd-Frank, most hedge funds were loosely regulated, and their managers were not even required to provide a name, address or size of their fund to regulators. Aimed at sophisticated investors, hedge funds for the most part were left alone to manage money at their own discretion provided that they operated within the law.

That attitude changed in October 2009 when Raj Rajaratnam, the manager of the New York-based Galleon Group hedge fund, was arrested on charges of insider trading.

It emerged that the enforcement case involving the Galleon Group came about as a result of examinations that the S.E.C. conducted in 2006 and 2007 at Sedna Capital, a hedge fund run by Mr. Rajaratnam’s younger brother, Rengan, and at Galleon.

During their inspections, S.E.C. examiners spotted some curious instant messages and e-mail exchanges between Rengan and Raj related to the semiconductor company Advanced Micro Devices. The examiners passed on the suspicious documents to lawyers in the S.E.C.’s enforcement division, which began a full-blown investigation of Galleon that culminated in criminal charges against its founder three years later. (Raj Rajaratnam was eventually convicted and is serving an 11-year sentence. Rengan Rajaratnam pleaded not guilty to insider trading charges in late March, but prosecutors have signaled that they are in plea discussions with him.)

In recent months, in advance of the S.E.C.’s visit, a number of London-based hedge funds managers have received letters requesting voluminous information. The letters seek documents like personal trading records as well as e-mails and instant messages. Many of the funds receiving such letters are newly registered investment advisers.

A spokeswoman for the S.E.C. declined to comment on the examinations.

While there is no suggestion that the hedge fund advisers are suspected of any wrongdoing, the inspections are not entirely random. With its limited resources, the S.E.C. is flagging hedge fund advisers that have a high concentration of retail investors or ones that it deems are at risk of not complying with United States regulations for a variety of reasons.

Some of the firms receiving requests include ones where the manager previously worked for a fund that had compliance issues with the S.E.C., or the investment adviser is pursuing a strategy that could make it vulnerable to missteps like insider trading.

The S.E.C. also appears to be examining so-called event-driven trading, related to major corporate news like merger deals. For much of this year, there has been a drought in European mergers; announced deals fell 42 percent, to $232.7 billion in the first six months, according to the data provider Thomson Reuters. But this month, the European merger scene came back to life: Verizon Communications agreed to buy Vodafone’s stake in Verizon Wireless for $130 billion and Microsoft said it would pay $7.2 billion for Nokia’s phone business.

Regulators in the United States in recent years have started crackdowns on insider trading at hedge funds, including actions against SAC Capital Advisors, founded by the billionaire Steven A. Cohen. But Britain has not seen a similar kind of regulatory cleanup even though stocks of target companies routinely trade higher in advance of an announced merger.

It remains to be seen just how aggressive the S.E.C. will be after it completes the exams. But the agency has promised that it will send the hedge fund managers a follow-up letter, saying either that no further action is necessary or specifying areas in which the hedge fund falls short and remedies are needed.

And overhanging the industry is always the worry that the examiners will stumble across the next Galleon, if they refer a case to S.E.C. enforcers.