SEC Probes Hedge Fund's Disclosure

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12/8/98 By MICHAEL SICONOLFI
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Federal regulators have launched an inquiry into whether **Long-Term Capital Management** LP fully disclosed the depth of its financial plight to potential investors when it was trying to raise cash before its near-collapse, according to people familiar with the matter.

At issue in the probe, being conducted by the Securities and Exchange Commission's enforcement staff, is the hedge fund's efforts to raise as much as $4 billion from investors in late August and September.

The inquiry comes after a Wall Street Journal article reported that Long-Term Capital principals, in a scramble to raise money as the fund continued to bleed, told investors they saw an incredible "opportunity" to reverse the hedge fund's fortunes if they only had more cash. Investors say the fund didn't disclose that it increasingly was using its cash to meet margin calls—demands for more collateral on money-losing trades that had been financed with billions of borrowed dollars.

SEC spokesman Chris Ullman said the agency, as is its custom, doesn't confirm or deny the existence of inquiries. In a statement, Long-Term Capital said it "is confident that its disclosure documents and supplements in connection with all investors at all times were in full compliance with all applicable laws, rules and regulations."

Profits Since Bailout

The SEC action comes as Long-Term Capital emerges from the depths of the recent global economic crisis. After losing more than 90% of the $4.7 billion in assets with which it began 1998, the fund has registered profits of about $400 million since the bailout amid the subsequent rebound in the markets, Wall Street traders say.

Long-Term Capital did, of course, disclose to investors it had lost money; the fund revealed on Sept. 2 that it had losses of $1.8 billion in August alone. But a 65-page private-placement memorandum dated Sept. 8, 1998, contained a typical boilerplate detailing the risks in the fund's investment strategy without disclosing the severity of the financial squeeze the beleaguered fund faced. Two weeks later, a consortium of Wall Street firms saved Long-

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Term Capital from collapsing with a $3.63 billion cash infusion.

The focus on Long-Term Capital marks a significant turn in the SEC's scrutiny of the matter. As previously reported, the SEC has begun an examination into dealings with hedge funds, including Long-Term Capital, by a half dozen of Wall Street's largest firms. This formal review is being conducted by staff from the SEC's office of compliance, inspections and examinations.

Following the near-collapse of Long-Term Capital, lawmakers ordered members of the President's Working Group to study whether new oversight was needed for the largely unregulated universe of hedge funds—investment pools for wealthy individuals and institutions—and the over-the-counter derivatives market. The Working Group includes the Treasury, Federal Reserve, SEC and Commodity Futures Trading Commission. The SEC's findings will be combined with those of the other regulators into a study that is due to be presented to Congress early next year.

Though hedge funds aren't regulated by the SEC, the agency still can pursue an enforcement action if it suspects a potential violation of securities law.

Among the potential investors who say they weren't fully informed of Long-Term Capital's desperate situation was Marlon Pease, finance director at the University of Pittsburgh, which had invested $5 million of its endowment into Long-Term Capital. After flying to the fund's Greenwich, Conn., headquarters to find out more about the fund's financial picture in early September, Mr. Pease said: "They gave us some information, but in retrospect, it wasn't as candid as it could or should have been." Mr. Pease didn't invest any additional money.

And when John Meriwether, Long-Term Capital's founder, called **Merrill Lynch** & Co.'s president, Herbert Allison Jr., in late August asking for more money, he said the fund had lost more money, but that he saw "real opportunity out there," according to Wall Street executives. Merrill officials first became aware of the depth of financial problems at Long-Term Capital only days before the rescue plan was cobbled together, the executives say. A Merrill spokesman declined to comment.

Technically, potential investors contacted in the capital-raising effort weren't harmed because Long-Term Capital never actually raised any new money. The fund unsuccessfully sought $1 billion in late August, and in September sought between $2 billion and $4 billion. The fund had pledges of more than $1 billion, but the capital-raising effort was contingent upon raising at least $2 billion. Before Long-Term Capital could meet the $2 billion threshold, however, the consortium stepped in to rescue the ailing fund.

"No closing date for these prospective investors was ever established and no sales of securities were ever consummated," Long-Term Capital said in the statement. "The need for supplemental disclosure was therefore obviated."

But the SEC still could bring an action under, among other things, Section 17a of the Securities Act of 1933, which prohibits the fraudulent sale of securities. If a case ever were brought, the fund could face several potential penalties, the most likely of which is an injunction requiring the fund to promise not to do it again, legal specialists say.

Yet winning such a case wouldn't be easy. The potential investors involved, which include some of the world's largest securities firms, are obviously sophisticated. And had they decided to invest, they could have delved more deeply and uncovered Long-Term Capital's severe financial straits as part of a "due diligence" effort.

All fund-raising efforts "were done on a private placement basis and were confined to a fairly small group of highly sophisticated investors, most of whom were already investors in the fund," Long-Term Capital said in the statement.

"All such prospective investors were invited to discuss the situation with authorized persons at LTCM or to visit the offices in Greenwich for an in-depth evaluation and many took the opportunity to do so," Long-Term Capital said.

The capital-raising bid was "directed to a group of clearly sophisticated deep pockets," says Edward Fleischman, a former SEC commissioner now with Linklaters & Paines, a law firm that has represented Long-Term Capital in certain matters. Pursuing such a case, he adds, would "certainly be a very unusual tack."

— Mitchell Pacelle contributed to this article.

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