SEC Starts Inquiry on Whether Trader Violated Rules Involving College Fund

WSJ
7/3/95 By MICHAEL GONZALEZ A2
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The Securities and Exchange Commission is launching an inquiry into whether a trader for a money-management firm violated federal regulations in losing an estimated $128 million for a big college-endowment investment fund.

People familiar with the inquiry said it would look into whether the trader—identified as Kent Ahrens, a 39-year-old senior trader with First Capital Strategists of York, Pa. — accurately recorded all his trades and whether they conformed to the requirements of the firm's client, the Common Fund.

The Common Fund, a Westport, Conn., educational asset-management concern that oversees about $20 billion in endowment money from 1,421 colleges and universities, said Mr. Ahrens violated the contractual obligations between the fund and First Capital.

David Storrs, president of the Common Fund, accused Mr. Ahrens of "not hedging his portfolio," as stipulated by the Common Fund's guidelines, for three years. Mr. Ahrens misrepresented his position to First Capital's four partners and to the Common Fund during that period, Mr. Storrs said.

Mr. Storrs added that while the loss would affect several Common Fund portfolios, none of them lost money as a result.

William McLucas, director of the SEC's enforcement division, confirmed that the agency had been contacted by the New York law firm engaged by the Common Fund, Cravath, Swaine & Moore, on Friday. In line with agency policy, Mr. McLucas declined to comment on whether there would be an inquiry.

Mr. Ahrens couldn't be reached to comment. First Capital wouldn't comment; in response to several telephone calls, a woman repeated "no comment" and hung up.

First Capital has managed a securities-lending pr m for the Common Fund since 1981, one year after First Capital was established. The firm manages about $1 billion for the Common Fund, and it is one of about 100 money-managment firms handling the Common Fund's 35 portfolios.

The First Capital program Mr. Ahrens ran for the Common Fund lends out securities from the Common Fund's other accounts to investors who want to short-sell those securities. In short selling, investors borrow securities and sell them in anticipation of a price decline; if they are right, they later repurchase the shares at a lower price and restore them to the accounts of the lenders.

To borrow the shares, short-selling investors put up collateral, which is invested by First Capital on its client's behalf. For the Common Fund, the collateral was invested in stock-index arbitrage programs, which capture profits from small, fleeting price discrepancies between stock index futures and the underlying stocks. Recently, Mr. Ahrens had about $350 million in stock-lending collateral to manage in stock-index arbitrage for the Common Fund.

Mr. Storrs said Mr. Ahrens told his superiors at First Capital last Monday that the portfolio hadn't been fully hedged. First Capital informed the Common Fund of the estimated $128 million in unrealized capital losses last Thursday. The Common Fund contacted the SEC and the Commodities Futures Trading Commission the next day.

Mr. Storrs said the problem may have begun as far back as 1992. "Three years ago, Mr. Ahrens did a transaction he wasn't able to hedge before the market

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closed. He took a small loss, we understand in the low five figures," Mr. Storrs said. The fund's policy is that its stock-arbitrage portfolio be neutral between long and short positions by the end of each day.

"At that point, he crossed the Rubicon," Mr. Storrs said of Mr. Ahrens. "He was determined not to let the market beat him and tried to get it back. He did a number of things for the next three years that turned what was supposed to be a conservative portfolio into a speculative one, which wasn't authorized."

For three years, Mr. Storrs charged, Mr. Ahrens "misrepresented" his portfolio's position at monthly meetings with First Capital's four partners.

Mr. Ahrens is now "remorseful and contrite. He has expressed his tremendous regrets and his desire to cooperate fully," Mr. Storrs said. The Common Fund hasn't asked First Capital to fire Mr. Ahrens because it is in the fund's best interest to have his cooperation, Mr. Storrs said.

Mr. Ahrens has been with First Capital for 12 years and enjoys some respect on Wall Street, according to people in the investment business. Though he isn't a partner of the firm, he is considered to be very senior.

Mr. Ahrens's short positions became nightmarish this year as the stock market rose to record after record, said Mr. Storrs. "He kept taking losses and had to keep increasing his bet."

In April, following the collapse of the British invesment bank Barings PLC due to a young trader's rogue behavior, the Common Fund decided to make sure that First Capital was following the guidelines fully. A review process was put into motion, and was to conclude at the end of June. It was in this review process that Mr. Ahrens realized he couldn't continue to conceal his true trading positions, Mr. Storrs said.

Nine of the Common Fund's 35 funds will be affected by the losses, Mr. Storrs said, though none will post a loss because of the alleged trading irregularities. The largest reduction in earnings due to the loss will be experienced by the Equity Income Fund, which will see its return for the fiscal year ended Friday reduced by 3.1 percentage points. However, Mr. Storrs added, it still returned a handsome 16.5%, which beats the fund's benchmark, the Lipper Equity Income Index, which had a return of 15.4% during that 12-month period.

Many of the details remain unclear. For example, Mr. Storrs said, "the amount of the loss is an estimate — First Capital's estimate, not ours — and it's based on incomplete records." He added, however, that he has no reason to doubt the estimate.

Cravath, the law firm representing the Common Fund, has retained the accounting firm Price Waterhouse. The Common Fund has also asked Goldman, Sachs & Co. to develop a plan to reduce remaining exposures.

The Common Fund's constituents are mostly small educational institutions, though it also has three large clients in the University of Michigan, Vanderbilt University and the University of Southern California. It informed all its members of the losses soon after being informed itself, Mr. Storrs said.