JOB TWO

CEO Aubrey McClendon ran a $200 million fund that invested in commodities produced by Chesapeake

MOONLIGHTING CEO: McClendon co-owned and was actively involved in a private hedge fund at the same time he ran Chesapeake Energy. "Strict codes" ban such dealing at most rivals, says one risk-management consultant. **REUTERS/SEAN GARDNER**

The CEO'S secret hedge fund

BY JOSHUA SCHNEYER, JEANINE PREZIOSO AND DAVID SHEPPARD

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As chairman and CEO of Chesapeake Energy Corp, Aubrey McClendon has been a powerhouse in the vast U.S. natural gas market, directing the company's multibillion dollar energy-trading operation and setting output targets for America's second-largest producer.

Behind the scenes, a Reuters investigation has found, McClendon also ran a lucrative business on the side: a $200 million hedge fund that traded in the same commodities Chesapeake produces.

On Tuesday, two weeks after Reuters reported that McClendon has taken up to $1.1 billion in loans against his stakes in Chesapeake oil and gas wells, the company stripped McClendon of the chairmanship and reiterated that it's reviewing details of the loans. A statement quoted McClendon, who will stay on as CEO, saying that the move will enable him to focus his "full time and attention on execution of the company's strategy."

But for at least four years, from 2004 to 2008, McClendon's attention extended well beyond his job at Chesapeake.

During that time, said a veteran trader who helped run McClendon's private hedge fund, the Chesapeake executive engaged in "near daily" communications and "exhaustive" calls to help direct the fund's trading.

The fund, Heritage Management Company LLC, was started by McClendon and Chesapeake co-founder Tom Ward. The hedge fund listed Chesapeake's headquarters in Oklahoma City as its mailing address, documents show. Heritage's staff included an accountant who was simultaneously employed by Chesapeake. The fund also earned McClendon and Ward management fees and a cut of profits from outside investors.

There is no evidence that McClendon or Ward used inside knowledge gleaned from Chesapeake in their hedge fund trading. Neither the company nor McClendon would comment, and Ward said he saw nothing wrong with the arrangement.

But experts on energy trading, corporate governance and commodity-market regulation said they were stunned by the latest revelation.

"An executive's first responsibility is to shareholders and the betterment of their investment," said Carl Holland, who ran the trading-compliance department at former U.S. oil major Texaco. "Personal trading in the commodity around which the CEO's business is based would be a clear no. We would never have tolerated that, ever."

Thomas Mulholland, a risk-management consultant to oil and gas producers for Golden Energy Services in St Louis, said such matters are "taken very seriously by energy companies, and there are strict codes against it. Even if there is just a whiff of impropriety," he said, "it can be enough to lead to a termination."

The commodities markets are less regulated than equity markets, where corporate executives are prohibited from trading stock in their own companies based on undisclosed financial information. In commodities markets, insider trading isn't illegal unless price manipulation can be proven.

Nonetheless, personal dealing in energy markets is typically forbidden by oil and gas companies for a variety of reasons.

In Chesapeake's case, McClendon would have been aware of major decisions that could affect natural gas prices before that information became public. Accounting for 5 percent of U.S. natural gas production, Chesapeake holds tremendous sway over markets. On Jan. 23, the company announced sharp output curbs in response to low prices. In response, U.S. natural gas futures surged by 8 percent the same day.

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>
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> Professor of securities law, Tulane University

"If the company needs to make an operating decision which might move the market against the CEO's positions, there's a risk that will influence the decision-making at the top of the company," said Jeff Harris, former chief economist at the market's U.S. regulator, the Commodity Futures Trading Commission, and now professor of finance at Syracuse University.

Another potential problem is known as "front-running." That's when a trader buys or sells a commodity in advance of a client's or his company's orders. In theory, McClendon's first-hand knowledge of Chesapeake's own plans to trade would enable him to profit by trading ahead of Chesapeake - a move that could raise costs for the company.

"Advance knowledge of Chesapeake's activities could be perceived as having insight into the movement of commodities prices, which certainly raises conflict-of-interest issues as well as ethical issues about the ability to enrich himself on non-public information," said Tim Rezvan, oil and gas industry analyst at Sterne Agee in New York.

"If correct," Rezvan said, "these disclosures would be even more alarming than the personal loans."

A securities law professor said the very existence of the hedge fund could prompt a securities investigation.

"I would argue, and I think the SEC would argue, that the failure to disclose that you are engaging in this kind of conduct can constitute a securities fraud problem," said Elizabeth Nowicki, a professor at Tulane University. She said a failure by McClendon and Ward to disclose their fund to Chesapeake's shareholders may constitute a "material omission" that could draw SEC scrutiny.

"A reasonable investor would want to know that the CEO could be in a situation where he's betting against the interests of the company personally," Nowicki said. "That, it seems to me, is a slam dunk."

An SEC spokesman declined to comment.

UNANSWERED QUESTIONS

It remains unclear whether McClendon received permission from Chesapeake's board to run a hedge fund and actively trade in the commodities markets for himself, or whether his trading continues. Chesapeake and McClendon's personal spokesman declined to comment.

Chesapeake also declined to say whether employees would be prohibited from operating such a hedge fund or trading their own cash in oil and gas markets. The issue isn't clearly addressed in a code of ethics published on Chesapeake's website.

Two Chesapeake board members contacted by Reuters declined to comment.

"Given litigation, we are constrained in what we can say," said Chesapeake spokesman Michael Kehs, who was referring to shareholder lawsuits filed in the wake of the Reuters report on McClendon's personal loans.

Oil and gas markets are secretive, and trading positions are almost never made public. McClendon's hedge fund partner Ward said the two were always careful not to let Chesapeake's decisions influence the hedge fund's endeavors.

Ward, who continues to trade his own personal cash in commodity markets and is now CEO of oil and natural gas driller SandRidge Energy, said he doesn't know whether Chesapeake's board knew of the hedge fund he ran with McClendon. But he said he sees "no conflict of interest."

"We did not use any proprietary knowledge of (Chesapeake) trades to make our own individual decisions," Ward said.

Peter Cirino, who helped trade natural gas for the hedge fund, also said he knew of no discussions about what Chesapeake was doing in energy markets: "They were much too smart as individuals," Cirino said of McClendon and Ward. "They would be able to manage that conflict there, if there was one."

Today, McClendon leads the three-man team that oversees Chesapeake's trading in oil and gas for the purposes of hedging, or offsetting the risk of unfavorable price swings. When Reuters asked McClendon last year whether he traded for himself in energy markets, McClendon said: "No, no, no. I'm part of Chesapeake's hedging committee."

That committee has helped Chesapeake "lock in" high prices for the gas it sells. This year, the company has not hedged. It told investors in a presentation that it doesn't expect natural gas prices - near 10-year lows - to continue falling.

The company's own trading has been a big success. "The bottom line is that Chesapeake has delivered $8.4 billion in realized hedging gains to shareholders since 2006," said Kehs, the company spokesman. "That's extraordinary shareholder value added through innovation and by far the best record in the oil and gas industry."

After Reuters disclosed McClendon's $1.1 billion in loans, Standard & Poor's cut Chesapeake's debt rating, citing "shortcomings" in corporate governance. The SEC and the Internal Revenue Service have begun probes in the wake of the loans report.

Chesapeake shares rose more than 7 percent on Tuesday on the news that McClendon is being replaced as chairman. After the stock market closed, the company reported a first-quarter net loss of $71 million. Its shares fell 5 percent in after-hours trading and are down almost 20 percent this year.

BIRTH OF HERITAGE

A search of Chesapeake's public filings turned up no disclosure of McClendon's hedge fund, Heritage.

Reuters traced its roots to Delaware, where it was registered in 2004 by Corporation Trust Company, a firm that helps companies incorporate. Another filing in New York, where Heritage employees executed many of the fund's trades, lists its mailing address as Chesapeake headquarters in Oklahoma.

A Heritage telephone number listed in several business directories was answered "Chesapeake Energy" by a person who said she hadn't heard of the fund. The fund is also listed in a database compiled by the National Futures Association, which doesn't disclose its owners.

Heritage also shared at least one employee with Chesapeake: John D. Garrison. Garrison, an accountant listed as executive business manager for Chesapeake Energy in federal election campaign donation filings and as a Chesapeake employee since 2004, handled the hedge fund's bookkeeping, Cirino said. The arrangement is not illegal.

Business directories including Dun & Bradstreet also list Garrison as Heritage's chief financial officer. Garrison declined to comment when a reporter visited his home near Oklahoma City.

Big Player

The largest bets on rising natural gas prices on June 30, 2008

OVER-THE-COUNTER NATURAL GAS SWAPS, NET LONG POSITIONS (Notional value, in billions)

Barclays	$28.79
Texas Competitive Electric Holdings	4.58
Boone Pickens	4.03
Morgan Stanley	2.37
Tom L. Ward	2.30
Aubrey K. McClendon	2.25
Bank of Montreal	2.12
AIG	2.02
Goldman Sachs	1.80
Shell	1.76

Source: Commodity Futures Trading Commission via Sen. Bernie Sanders

Heritage was born when commodity trader Cirino and four other traders went searching for capital to start a hedge fund, Cirino said. Through industry contacts, they landed a coveted audience with McClendon and Ward, already famed Oklahoma drillers before becoming pioneers of the shale-gas boom.

The Chesapeake founders, Cirino recalled, agreed to seed the fund with a total of $40 million of their own cash. But McClendon and Ward insisted on full ownership and involvement in the fund's trading strategy, Cirino said.

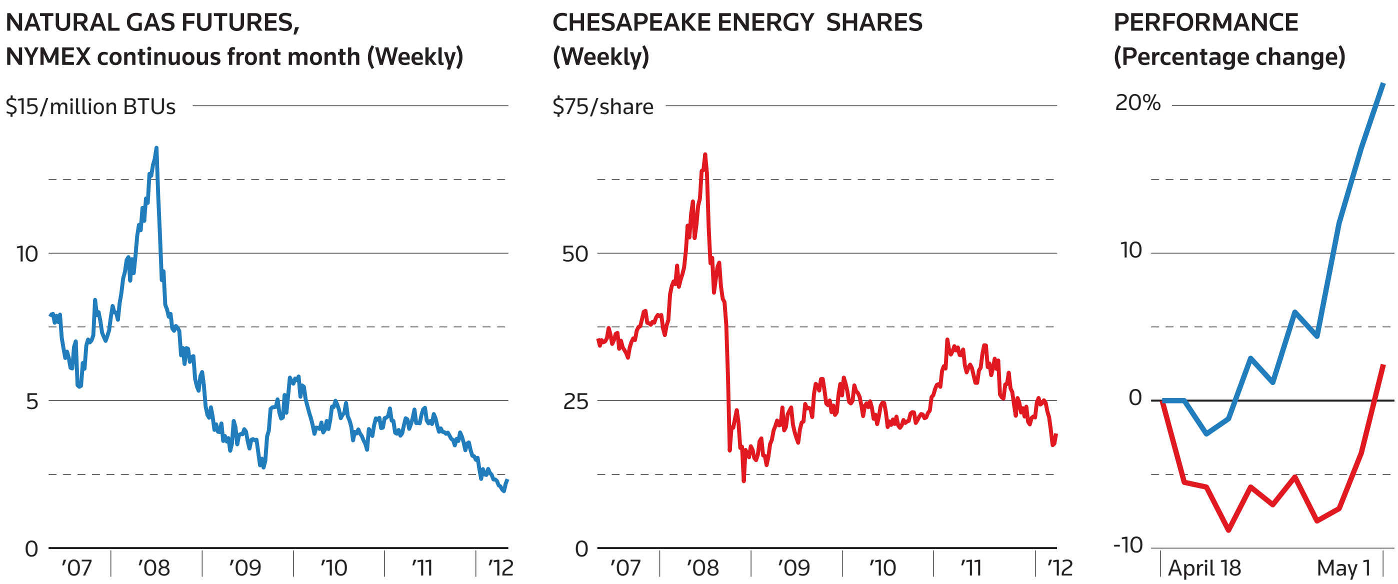
"They took a leap of faith to invest money in us, so we knew we were on the line," said Cirino, Heritage's former head trader and risk officer. "That they were in charge was made very clear."

The fund's trading wasn't limited to energy markets. It bet on a variety of goods, from natural gas to cocoa and coffee. It even had a cattle trader in Oklahoma.

As Heritage racked up stellar returns of between 15 to 25 percent a year, McClen-

Well of trouble

Chesapeake share performance closely tracked natural gas prices until an April 18 Reuters report that McClendon borrowed $1.1 billion against his stakes in company wells.



Source: Thomson Reuters

don and Ward decided to open the hedge fund to outside investors, including friends and associates, Cirino said. When Ward left Chesapeake in 2006, he retained his stake in the fund.

By 2007, Heritage was managing around $200 million, Cirino said. That enabled Ward and McClendon to profit in another way: by charging outside investors a management fee equal to 2 percent of assets and pocketing 20 percent of the fund's profits. It's a typical structure in the hedge fund industry, known as "2 and 20."

Cirino and Ward's recollections differ on at least one point. Ward said he didn't interact with the fund's outside investors. Cirino recalled that "every investor I was involved with either met with McClendon and Ward or at least spoke with them by phone before investing." The hedge fund's healthy gains were a lure, but "the cachet of those two individuals certainly also helped," Cirino said.

In addition to weekly Monday conference calls and regular emails, the two owners met frequently with traders in New York and occasionally in Oklahoma, Cirino said.

In 2007, as the price of natural resources surged on booming demand from China and other fast-developing countries, commodity traders with a successful track record were popular on Wall Street. After three years of double-digit returns, the fund's traders told McClendon and Ward they wanted an equity stake, Cirino said.

But the executives weren't ready to cede control, Cirino said, and the traders left to open their own shop, Perennial Capital LLC, a $200 million fund that has no financial ties to McClendon or Ward. Cirino said the departure was amicable.

At Heritage, all of the money from external investors was returned by 2008, Cirino said. McClendon and Ward continued to operate the fund during that year, Ward said, but by 2009, Heritage traded no more.

What happened next to McClendon's commodity-trading ventures is unclear.

By June 2008 - as natural gas and oil prices were peaking, and just before the financial crisis - McClendon and Ward both held huge positions in natural-gas derivatives, according to confidential trading data disclosed last year by U.S. Senator Bernie Sanders, an independent from Vermont.

The trading information was assembled as part of a CFTC inquiry into derivatives markets and their impact on real-world energy prices. McClendon and Ward were among only a handful of individual investors identified by the CFTC. Most of the other players were big corporations.

The data indicated McClendon and Ward were betting that the rally of 2008 would continue. By purchasing derivatives, they controlled nearly identical positions in natural gas worth around $2.3 billion apiece, according to Reuters calculations based on closing futures prices as of June 30, 2008. McClendon held oil contracts worth another $240 million, the CFTC data showed.

Of 300 banks, hedge funds, energy companies and other traders identified in the CFTC survey, only four held larger bullish bets in natural gas.

Oil fell by more than 75 percent between July and December. Natural gas futures dropped almost 60 percent.

It isn't clear how McClendon and Ward's investments fared. McClendon would not discuss his trading. Ward said he could not recall the outcome of his own trades in 2008.

McClendon suffered a well-documented personal cash crunch later that year, however.

In early 2008 McClendon held a big position in Chesapeake stock purchased with borrowed money. Later that year, margin calls from his brokers forced McClendon to unload more than 90 percent of his Chesapeake shares and suffer a $2 billion paper loss. His selling contributed to an 88 percent fall in Chesapeake's share price from its all-time high of $74 that year. Chesapeake has since restricted "leveraged" trading in the company's shares by its executives.

Months later, McClendon became one of the highest paid CEOs in America for the year, receiving a total compensation package worth $112 million. The payout included a one-time cash bonus of $75 million to help him meet requirements for paying the costs of his personal stakes in Chesapeake-owned wells.

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DATA DISCLOSED : Vermont Senator Bernie Sanders released confidential trading data that showed that by June 2008, McClendon and Chesapeake co-founder Tom Ward held huge positions in natural gas derivatives. **REUTERS/BRIAN SNYDER**