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Spotlight On Hedge Fund Trading Activities

Law360, New York (December 14, 2009) -- Criminal and civil complaints filed by the U.S. Department of Justice and the Securities and Exchange Commission against 20 individuals in two separate waves during the last two months signal a new, aggressive posture taken by the federal agencies in pursuing insider trading activities at hedge funds.

To develop these cases, federal prosecutors took a page out of their organized crime-busting playbook by patiently using wiretaps, cooperating witnesses and surreptitious consensual recordings over a period of nearly two years to capture conversations among defendants, including Galleon Group founder, Raj Rajaratnam, and others.

In the wake of these charges, hedge fund managers should expect greater law enforcement scrutiny of trading practices and should use the occasion to re-examine the adequacy of compliance regimes designed to prevent insider trading and protect hedge fund firms and their employees from reputational harm, financial loss and criminal prosecution.

The Recent Cases

On Oct. 16, 2009, federal prosecutors charged six individuals, including Rajaratnam and employees of hedge fund manager New Castle Partners, with criminal conspiracy and securities fraud crimes based on allegations that the hedge fund defendants regularly traded on material, nonpublic information tipped by insiders at major public companies and other firms.

The DOJ alleged that the scheme earned more than $20 million through illegal trades and labeled the takedown “the largest hedge fund insider trading case in history.”

The case against Rajaratnam was long in the making — prosecutors apparently began the investigation in 2007, when a former Galleon employee began cooperating with the Federal Bureau of Investigation after being caught trading on inside information.

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Prosecutors followed up the Rajaratnam case with an announcement on Nov. 5, 2009, that criminal conspiracy and insider trading charges had been filed against 14 additional individuals, including hedge fund managers and employees of other firms.

There are numerous indications that the government's investigation is continuing and that these cases will not be the last.

At the time the Rajaratnam complaint was announced, prosecutors stated that the case should serve as "a wakeup call" for hedge fund managers and Wall Street traders and warned that they may be listening to conversations in the future.

More recently, prosecutors announced the guilty pleas of five defendants who are cooperating with the government's ongoing investigation into insider trading at hedge funds.

Strengthening Your Compliance Regime

These recent actions leave no doubt that federal law enforcement agencies have developed a significant interest in hedge fund trading activities, and the ability of the DOJ and the SEC to develop sufficient evidence to bring charges against Rajaratnam and others make it evident that government attention is unlikely to abate any time soon.

Hedge fund managers should expect that their trading activities may face increased government scrutiny and should use this occasion to examine the efficacy of their compliance regimes.

As Robert Khuzami, the director of the SEC's Division of Enforcement succinctly stated on the day the Rajaratnam charges were announced:

"It would be wise for investment advisers and corporate executives to closely look at today's case, their own internal operations, and the increasing focus and scrutiny on hedge fund trading activity by the SEC and others, and consider what lessons can be learned and applied to their own operations."

In particular, hedge fund managers should carefully consider how the written communications and conversations of their employees might be perceived by law enforcement agencies and should consider how they might fortify their own operations against a rogue employee who could jeopardize the future of the firm.

Some steps to think about include:

- Consider reviewing and strengthening existing firm policies related to insider trading, including policies for determining when information is likely to be material and when it ceases to be nonpublic;

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- Consider adopting clearly defined procedures for addressing close questions, documenting their resolution and obtaining trade clearances;

- Consider implementing training programs to ensure that employees throughout the firm understand, and comply with, relevant firm policies and procedures;

- Consider utilizing certifications to secure employee commitments to honor firm policies and procedures;

- Consider obtaining conversation-specific representations from consultants and other sources of information that they are not conveying material nonpublic information, and are otherwise not conveying information protected by a duty of confidentiality;

- Consider the advantages and disadvantages of implementing an employee surveillance program, including selective monitoring of employee e-mails, instant messages and phone lines;

- Consider the advantages and disadvantages of blocking employee access in the workplace to personal Web-based e-mail accounts and other non-essential Web sites, including social networking Web sites such as Facebook, Twitter and MySpace;

- Consider the advantages and disadvantages of limiting the use of personal cell phones in the workplace;

- Consider the advantages and disadvantages of limiting personal trading by employees; and

- Consider whether the firm has allocated sufficient resources to support its compliance efforts.

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