Hedge Fund Law Report
An Acuris company

Insider Trading

Paul Hastings Hosts Program on Securities Litigation and Enforcement in Light of New SEC Initiatives to Enhance Enforcement Efforts and Encourage Witness Cooperation

Feb. 11, 2010

By Jennifer Banzaca, *Hedge Fund Law Report*

On February 2, 2010, law firm Paul, Hastings, Janofsky & Walker LLP hosted a Securities Litigation & Enforcement Roundtable focusing on key current enforcement and witness cooperation initiatives at the Securities and Exchange Commission (SEC).

The SEC Enforcement Division, led by Director Robert Khuzami, recently introduced new investigative units designed to enhance and revamp its investigation efforts, as well as to encourage witness cooperation in investigations. See "SEC Names New Co-Chiefs of Enforcement Division Asset Management Unit and Other Specialized Unit Chiefs," Hedge Fund Law Report, Vol. 3, No. 3 (Jan. 20, 2010). The speakers also discussed the implications of these initiatives and current enforcement trends for financial institutions and alternative investment vehicles, such as hedge funds.

One of the key points of the discussion was the SEC's increased emphasis on insider trading enforcement, in particular in the hedge fund context. The SEC has increased the number of insider trading enforcement actions recently initiated, and the techniques used by the regulator to investigate suspected insider trading have become increasingly aggressive and sophisticated. For a comprehensive discussion of practice points that can help hedge fund managers avoid insider trading allegations, including links to relevant articles from the Hedge Fund Law Report, see "Regulatory Compliance Association Hosts Program on Increased Risk for Hedge Fund Directors and Officers in the New Era of Heightened Regulation and Enforcement," Hedge Fund Law Report, Vol. 2, No. 50 (Dec. 17, 2009).

This article summarizes the most relevant topics discussed at the Paul Hastings Roundtable, focusing on the SEC's new enforcement initiatives and cooperation measures (including cooperation agreements, deferred prosecution agreements and non-prosecution agreements), and emphasizing the potential impact of those measures on hedge funds and their managers.

New SEC Investigative Units

Last month, in the most expansive endeavor to revamp its enforcement efforts to date, the SEC named six chiefs to head its new investigative units. The units and their leaders are: Asset Management, led by Bruce Karpati and Robert Kaplan; Market Abuse, led by Daniel Hawke;

Structured and New Products, led by Kenneth Lench; Foreign Corrupt Practices, led by Cheryl Scarboro; and Municipal Securities and Public Pensions, led by Elaine Greenberg.

Speakers at the Paul Hastings event noted that this reworking of it investigative unit is a significant initiative for the SEC and could lead to more investigations. Barry Sher, Chair of the firm's New York Litigation Practice noted, "We are seeing some increased activity in enforcement. We're seeing more Ponzi scheme cases, more insider trading cases. And, there is certainly more of a focus on individuals."

Indeed, the SEC has said there will be increased enforcement. Khuzami has remarked that the Enforcement Division will increase its enforcement activity with respect to insider trading by hedge funds. See "Big Boys Don't Cry: How 'Big Boy' Provisions Can Help Hedge Fund Managers Avoid Liability for Insider Trading Violations," Hedge Fund Law Report, Vol. 2, No. 48 (Dec. 3, 2009).

With more specialized teams focus on different areas of the market – and more employees knowledgeable in their given areas of enforcement – the SEC is expected to be more industrious in its investigation efforts, from gathering of evidence, to determining liability to filing charges. As Kenneth Breen, a Partner in the firm's Litigation Practice, noted, "The SEC is looking into more aggressive and sometimes altogether new theories of culpability."

Allegations that a defendant knew or should have known it was trading on inside information are an example of an area of culpability the SEC is considering, according to speakers at the event. However, the SEC faces a recurring stumbling block in the form of its requirement to demonstrate a breach of fiduciary duty by the defendant, Breen noted.

Recent Insider Trading Actions

The SEC has brought several notable insider trading cases recently. Perhaps most notable was the October 2009 filing of criminal charges against several people involved with the Galleon Group family of hedge funds and New Castle Funds, LLC, for allegedly engaging in a massive insider trading scheme. Specifically, the government accused Raj Rajaratnam, founder and manager of Galleon, Mark Kurland, a top executive at New Castle, and Danielle Chiesi, a New Castle employee, of contacting a network of close business associates, including Rajiv Goel, a managing director at Intel Capital, Anil Kumar, a director at McKinsey & Company, Robert Moffat, an IBM senior executive, and one another, to obtain confidential information about corporate earnings and takeover activity at several public companies. See "Billionaire Founder of Hedge Fund Manager Galleon Group, Raj Rajaratnam, Charged in Alleged Insider Trading Conspiracy," Hedge Fund Law Report, Vol. 2, No. 42 (Oct. 21, 2009); "Best Practices for a Hedge Fund Manager General Counsel or Chief Compliance Officer that Suspects or Discovers Insider Trading by Manager Employees or Principals," Hedge Fund Law Report, Vol. 2, No. 48 (Dec. 3, 2009).

In November, the SEC and the U.S. Attorney's Office for the Southern District of New York announced the indictment of Joseph Contorinis, a former Jefferies Group, Inc. hedge fund portfolio manager, on charges of conspiracy and securities fraud relating to his alleged participation in an insider trading conspiracy ring. See, "Another Hedge Fund Manager, Former Jefferies Group Manager Joseph Contorinis, Indicted for Insider Trading," Hedge Fund Law Report, Vol. 2, No. 46 (Nov. 19, 2009).

Keith Miller, also a Partner Paul Hastings' Litigation Practice, simply stated, "Obviously we're seeing a ramp up of insider trading cases and we'll continue seeing similar cases."

New Trends in Insider Trading Investigations

Because there is no outright prohibition of insider trading in the various securities statutes, most insider trading prosecutions are brought under the general anti-fraud provisions of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder.

Section 10(b) of the Exchange Act provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange, to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

SEC Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, to employ any device, scheme, or artifice to defraud, to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Liability for insider trading generally requires proof of five elements: (1) materiality of information; (2) nonpublic information; (3) scienter; (4) reliance by the plaintiff; and (5) a breach of fiduciary duty. For more on these elements and how they apply in specific contexts, see "Regulatory Compliance Association Hosts Program on Increased Risk for Hedge Fund Directors and Officers in the New Era of Heightened Regulation and Enforcement," Hedge Fund Law Report, Vol. 2, No. 50 (Dec. 17, 2009).

The two prevailing theories of insider trading are the "classical" or "traditional" theory, and the "misappropriation" theory.

At a very general level, under the classical theory, a person is deemed to have violated the insider trading law by buying or selling securities based on material, non-public information obtained from an insider at a corporation who breached a duty of trust owed to the corporation's shareholders. The misappropriation theory generally applies in cases where a person misappropriates confidential information and buys or sells securities based on information, in breach of a duty owed to the source of the information.

Sher noted that in recent enforcement actions, the SEC has been attempting to redefine and narrow the fiduciary duty requirement (which of course would expand the range of insider trading liability).

Distinguishing Between Market Chatter and Inside Information

While the SEC is stepping up its investigations of insider trading violations, hedge funds must be wary of the subtle distinctions between market chatter and inside information. In the course of researching possible investments, hedge fund managers collect, analyze and act on a significant volume of complex information. In doing so, they often talk to corporate insiders. In the course of such discussions, hedge fund managers may legally obtain facts and opinions that, when combined with other immaterial, nonpublic or material public information constitutes a "mosaic." However, no circumstance may hedge fund managers obtained in trade based upon material, nonpublic information. See "How Can Hedge Fund Managers Distinguish Between Market Color and Inside Information?," Hedge Fund Law Report, Vol. 2, No. 46 (Nov. 19, 2009); "How Can Hedge Fund Managers Talk to Corporate Insiders Without Violating Applicable Insider Trading Laws?," Hedge Fund Law Report, Vol. 2, No. 43 (Oct. 29, 2009).

"What is market chatter and what is insider trading?" Sher asked rhetorically. "From a prosecutorial sense, you have to separate out the norm of people communicating and sharing thoughts and ideas from what's actually illegal. That's why breach of fiduciary duty or breach of duty concept is so important, because unless you're getting information from someone who has a duty to keep it confidential, then it's just chatter."

Cooperation Agreements

Aside from restructuring its enforcement division, the SEC also recently announced plans to encourage individuals to cooperate with the agency's investigations and enforcement actions through cooperation agreements and deferred and non-prosecution pacts.

According to the SEC, cooperation agreements are formal written agreements in which the Enforcement Division agrees to recommend to the SEC "a cooperator receive credit for cooperating in investigations or related enforcement actions if the cooperator provides substantial assistance such as full and truthful information and testimony."

Deferred prosecution agreements are formal written agreements in which the SEC "agrees to forego an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully and to comply with express prohibitions and undertakings during a period of deferred prosecution."

The final type of agreement, non-prosecution agreements, are "formal written agreements, entered into under limited and appropriate circumstances, in which the Commission agrees not to pursue an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully and comply with express undertakings."

The speakers at the roundtable concurred that the effect of these agreements is unclear because, for now, it is difficult to determine if more people will come forward with information about possible insider trading cases. Nonetheless, these new tools, which are designed to encourage cooperation, have the potential to strengthen the Enforcement Division's ability to investigate and build cases. In designing its new cooperation rules, the SEC seeks to encourage to report illegal activity and to give them an incentive to do so. Prior to these new measures, the SEC did not entertain discussions concerning non-prosecution agreement or deferred prosecution agreements. In a word, the SEC's new cooperation tools borrow from the prosecutor's toolbox, not surprising, given the prosecutorial pedigree of Director Khuzami and other Enforcement Division personnel.

"The SEC is starting to look more and more like the DOJ these days," Miller stated. "With the SEC's recent proposal to enter into cooperation agreements, deferred prosecution agreements

and non-prosecution agreements, the SEC is beginning to understand the importance of providing incentives for individuals to report information. I think as a result of these new sea changes, you're going to see more information and potential evidence being collected by the staff, which ultimately should translate into more cases."

Miller continued: "Because of the SEC's recent proposals concerning cooperation and as a result of the publicity regarding recent insider trading cases, I suspect we will see more insider trading cases being brought by prosecutors. A similar effect occurred with the Madoff case. Once the Madoff scheme was revealed, more and more Ponzi schemes were uncovered. People involved in trading may well be anxious and worried about possible consequences to them, and may want comfort. As a result, they may decide that it is in their best interest to cooperate in order to obtain credit through an agreement."

However, Breen argued that the big question is whether cooperating with the SEC will have any bearing on possible criminal actions taken by the Justice Department. "A big question right now is what level of cooperation is the SEC going to have with the DOJ in future investigations, because different rules apply in civil and criminal proceedings, and coordinating and sharing information can have consequences."