Hedge Fund Law Report
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Insider Trading

Former Deputy U.S. Attorney and WilmerHale Partner Boyd M. Johnson III Addresses Risk Management Imperatives for Hedge Fund Managers: Insider Trading, Defense Strategy, Crisis Management, Money Laundering, Cyber Security and Tax Shelters

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By Jennifer Banzaca, *Hedge Fund Law Report*

Risk plays a different role in investments and operations. In investments, as a general matter, returns are broadly correlated with risk. In operations, on the other hand, quality tends to be inversely related with risk; there is no greater upside potential from increased operational risk, just a greater likelihood of fundamental error. At the same time, operational risk is generally more dangerous to hedge fund managers than investment risk. Investors understand that generating returns inevitably involves mistakes, but operational failures call into question a manager's basic competence as a steward of capital.

Managing and mitigating operational risk are thus increasingly critical aspects of the hedge fund business. But doing so is easier said than done. In the first instance, it is challenging to identify the full range of operational risks facing a manager. There is a group of usual suspects, but the less obvious and more insidious risks are unique to a manager's strategy and operations. Once risks are identified, best practices for addressing risks are hard to come by.

In an effort to assist hedge fund managers on both counts – identifying relevant risks and deciding what to do about them – the Hedge Fund Law Report recently interviewed Boyd M. Johnson III, a partner in the Litigation/Controversy Department and member of the Investigations and Criminal Litigation Practice Group and the Business Trial Group at WilmerHale. Prior to joining WilmerHale, Johnson served as Deputy U.S. Attorney in the Southern District of New York with supervisory authority over 230 Assistant U.S. Attorneys. As Deputy U.S. Attorney, Johnson managed the largest crackdown on Wall Street insider trading in history, including the prosecution of Raj Rajaratnam of the Galleon Group; criminal prosecutions and civil forfeiture proceedings related to the Bernard Madoff fraud; the investigation and prosecution of individuals and entities responsible for structuring and promoting international tax shelters; and numerous cyber security and other investigations. For our interviews with other leading prosecutors in the Rajaratnam insider trading case, see "Former Rajaratnam Prosecutor Reed Brodsky Discusses the Application of Insider Trading Doctrine to Hedge Fund Research and Trading Practices," Hedge Fund Law Report, Vol. 6, No. 13 (Mar. 28, 2013); and

"Rajaratnam Prosecutor and Dechert Partner Jonathan Streeter Discusses How the Government Builds and Prosecutes an Insider Trading Case against a Hedge Fund Manager," Hedge Fund Law Report, Vol. 5, No. 45 (Nov. 29, 2012).

The bulk of our interview with Johnson covered various aspects of insider trading – not surprising, given that insider trading remains *primus inter pares* among the various risks faced by managers in many strategies. Specifically, with respect to insider trading, we discussed with Johnson: challenges in defending simultaneous civil and criminal insider trading actions; challenges in coordinating defenses to insider trading charges levied by multiple jurisdictions; considerations in evaluating an insider trading plea deal; strategies for obtaining prosecutorial leniency in insider trading cases; addressing insider trading risks from communications among investment professionals at different managers; maximizing the effectiveness of insider trading training; insider trading crisis management; and strategies for documenting findings from insider trading internal investigations. Beyond insider trading, we also covered: anti-money laundering (AML) and cyber security risks confronting managers; identifying risky tax shelter pitches; and navigating fraud risks in healthcare investing.

This interview was conducted in connection with the Regulatory Compliance Association's upcoming Regulation, Operations & Compliance 2013 Symposium, to be held at the Pierre Hotel in New York City on April 18, 2013. That Symposium is scheduled to include a panel covering government investigation and prosecution of hedge fund and private equity fund managers entitled "Post SAC Capital – Investigation, Enforcement & Prosecution of Hedge & PE Managers." Subscribers to the Hedge Fund Law Report are eligible for a registration discount.

HFLR: In addition to developing a compelling theory of their defenses, hedge fund portfolio managers and others that become the subject of simultaneous civil and criminal insider trading charges must consider various strategic and procedural issues. In your experience as a long-serving and successful prosecutor, and now on the defense side, what are the foremost challenges faced by hedge fund managers in coordinating the defense of simultaneous civil and criminal insider trading charges?

Johnson: The biggest challenge is to get the civil and criminal authorities to coordinate among themselves. The SEC and the Department of Justice (DOJ) have different ways of operating; their standards of proof are different, and the investigative techniques they use can be different. So, you need to try to bring the regulators together and your information and your defense to both authorities at the same time to minimize misunderstandings. That's the most efficient way for the hedge fund manager to proceed.

There are a number of U.S. Attorney's offices who coordinate very well with the SEC and help to minimize this challenge. But there can be other situations where the coordination between the SEC and the DOJ is not as strong. In those situations, it's the challenge of the hedge fund manager to defend the matter in a way that brings those two parties together. You need to make sure that the DOJ and the SEC are talking to each other because there may be a situation where your defense is that the SEC may have some action, but the matter does not rise to a criminal level, and, in that case, you want there to be dialogue between the SEC and the DOJ so that they appreciate that difference.

HFLR: Similarly, the same acts or omissions may give rise to simultaneous insider trading or insider dealing charges by securities regulators from different jurisdictions. How should hedge fund managers coordinate the defense of charges from different jurisdictions, in particular where the conduct at issue is legal in one jurisdiction but illegal in another?

Johnson: Yes. This is not a hypothetical concern. We have recently seen the Financial Services Authority (FSA) in the U.K. become very active in insider dealing enforcement, and there are

more and more investigations where both the FSA and the SEC have jurisdiction over an insider trading scheme that extends from the U.S. to the U.K. That is a very challenging situation because the laws are different, the standards are different and the methods of investigation and prosecution are different. The first thing to do is make sure that the hedge fund manager understands all the jurisdictions in which it is operating and the insider trading schemes within those jurisdictions. That's really the beginning of this process. Once you're aware of how insider trading laws work in the relevant jurisdictions, you need to proactively plan how to respond to a particular investigation. Obviously, conduct that is illegal in one jurisdiction may not be illegal in another, so, you need to focus on the jurisdiction in which the activity is illegal. Again, one of the important things to do is to ensure that the regulators in the different jurisdictions are cooperating with each other. The worst thing you can face is a turf battle between jurisdictions, as opposed to cooperation.

HFLR: What factors should a hedge fund investment professional weigh in determining whether to accept or reject a plea deal from the government relating to insider trading charges?

Johnson: That really depends on the facts and the individual professional. Obviously, if we're talking about a criminal situation, it's important for the professional to consider the amount of jail time she would face as part of a plea deal versus after a conviction at trial. To the extent we're not talking about conduct that rises to the criminal level, a key consideration will be the collateral consequences of an adverse decision. These consequences can include a ban from the industry for a period of time, a lifetime ban from the industry or the inability to serve in a certain capacity as an investment management or securities professional. In the end, the decision to accept or reject a plea deal is a personal choice, one the professional needs to enter into after consulting counsel and discussing and weighing the options thoroughly.

HFLR: What categories of leverage have been, in your experience, effectively deployed by hedge fund investment professionals in either persuading the government not to bring criminal insider trading charges, or in persuading the government to impose less onerous terms in a plea agreement?

Johnson: Yes. When I was the Deputy U.S. Attorney for the Southern District of New York, I was often on the other side of the table from defense counsel for hedge funds arguing for leniency. One of the most effective arguments I heard happened when the defense lawyer showed that the investment professional had taken a concern to the compliance or legal department and proactively raised their concerns. That showed me as a prosecutor that the professional and the fund manager were trying to get to the right answer, were trying to comply with the law, not break it, and were trying to make sure they understood the import of the information they had obtained. I can remember situations where trades were placed on information that could have been perceived as material nonpublic information, but the fact that the analyst or the portfolio manager went to the compliance department and counsel with their concerns demonstrated to me that they acted in good faith. It really comes back to having a culture of compliance, being able to evidence that the culture was working and that the professional did not have corrupt intent.

HFLR: Part of the conduct at issue in the smaller of the recent settlements between the government and affiliates of SAC Capital involved "chatter" exchanged between investment professionals at various hedge fund management companies. How should hedge fund managers structure and enforce their compliance policies and procedures to adequately cover interactions between investment professionals at different management companies? Also, should work history, educational background or friendship networks plan an explicit role in structuring insider trading policies and procedures?

Johnson: Hedge fund managers have taken different approaches to this issue. On the one hand, you can take a very conservative approach that says investment professionals from one firm should never communicate with their colleagues at other firms. That certainly serves to mitigate risks that you will obtain inside information. On the other hand, that greatly inhibits the ability to test ideas appropriately with people one respects in the industry.

Alternatively, you could take the approach where you do not have any restrictions at all on the communications that happen between investment professionals at different firms. The consequence of that approach of course is the potential for material nonpublic information to come into your firm from another firm where compliance may not be as rigorous. This is a question of balancing risks and building a compliance environment that is appropriate for your firm. But any of these approaches must begin with an understanding of the basics of the definition of material nonpublic information. Whether an analyst is talking to their roommate from college or an expert from a consulting firm or someone on the sell side, their antenna needs to be constantly raised up to the potential of obtaining material nonpublic information in breach of a duty of confidentiality. Once you have a culture of compliance that encourages that awareness, for the firm and for the individual investment professionals, and one that has a tone from the top with zero tolerance for insider trading, you are really there. It all comes back to basics – making sure everyone is trained on what inside information is, what the risks are and what the proper steps are to take in obtaining information from outside of the firm in the course of conducting legitimate research.

HFLR: Speaking of training, you have trained analysts, traders and portfolio managers at hedge fund managers on insider trading risks. In your experience, what are two or three training methods or messages that are actually effective in reducing insider trading risk at a manager?

Johnson: The first is for people to be made aware of the risks, which include substantial jail time, the destruction of the enterprise and being banned from the industry. When I conduct trainings, I tell stories about the cases I saw as a prosecutor, including the serious jail sentences, to impress upon the professionals that insider trading is not only wrong, but is simply not worth the risks. The second training technique that is effective is to use hypotheticals. We train on the law of insider trading, and we talk briefly about some of the cases. However, we always try to build hypotheticals that are as close to reality as possible and to discuss them with the investment professionals.

A third step we take is to make sure that, at the training, everyone who is there knows who their compliance officer is and who the in-house counsel are. You would be surprised, with the turnover in this industry, that there are instances in which the analysts and traders are not aware of who is in charge of the legal or compliance department. And I always make sure to include the chief compliance officer and the general counsel in the training because when I walk out of the door, it's going to be the general counsel or chief compliance officer in charge of this environment day-to-day.

HFLR: Should training on insider trading risk solely be directed at investment professionals at a manager, or should such training also be directed at noninvestment personnel in legal, compliance, operations, accounting, finance and marketing? If so, should such training be conducted differently for investment and noninvestment professionals?

Johnson: I encourage everyone to come – operations, accounting, finance and even the marketing people. On the marketing front, I have increasingly come to believe that investors really do care about compliance and about the risk of negative publicity associated with even an investigation. I think that it's important for people who market hedge funds to understand the

rules of the road and the compliance environment at their firms. If an effective culture of compliance is going to exist, it cannot just be limited to the investment professionals, it has to be one that is embraced by every employee.

HFLR: You advise business organizations on crisis response and media relations. While no hedge fund manager wants an insider trading violation to occur within its ranks, once such a violation does occur, the manager inevitably has to think about how to disclose the violation to various constituencies – including the public and the media. How would you advise a manager with a discovered violation to go about disclosing that violation to the public and the media in a way that minimizes long-term harm to the business?

Johnson: First and foremost, you need to have your arms completely around the facts, and you need to understand exactly who was involved in the conduct and how extensive it was. To the extent you have a rogue actor, there is a story to be told because even if there is a robust compliance program in place, the unfortunate reality is that any system of controls can be circumvented. The idea in that situation is to proactively try to get ahead of the story as much as possible. There are a lot of institutions that unfortunately have had to deal with rogue actors, but they do not necessarily go out of business: they survive because they are proactive. They deal aggressively and decisively with the bad actor, and they are transparent to investors, shareholders, regulators and, ultimately, the public. The challenge is to ensure that you understand all of the facts, proactively try to manage the story while cooperating fully with the authorities and make sure that you are transparent with investors.

HFLR: If a hedge fund manager directs outside counsel to undertake an internal investigation of suspected insider trading, should that outside counsel prepare a written report of the internal investigation or only deliver its findings orally?

Johnson: That's a case by case determination. Certainly the risk of preparing a written report is that it can ultimately be discoverable in some situations. On the other hand, the benefit of preparing a written report is that it can, in some cases, be clearer than an oral presentation. Ultimately, whatever the form of the findings, they need to be complete and clear, and enable the manager to take decisive action to move the organization forward in the right direction.

HFLR: You have also trained hedge fund professionals on anti-money laundering risks. In your experience, what are the most salient AML risks facing hedge fund managers and how do those risks inform the content of your training?

Johnson: Investment advisers are not subject to many of the anti-money laundering rules under the Bank Secrecy Act. However, there are certain reporting requirements that do apply, such as CTRs and CMIRs reporting related to the receipt of and transfer of large amounts of cash. More broadly, the concern is the source of the money. The hedge fund manager needs to know the source of the funds and the people behind that money. Even though hedge fund managers are not formally under the jurisdiction of the Bank Secrecy Act, they still have a responsibility to do AML work, and I have seen managers becoming increasingly engaged with respect to AML requirements. I think they have seen a lot of the settlements with the larger financial services firms that have come out and have realized the laser focus of the DOJ and other agencies on these issues. The reputational risk of being associated with a money laundering investigation I think is driving managers towards more and more robust AML programs.

HFLR: Cyber security generally is another of your focus areas. Combining that with your hedge fund litigation and investigations experience, are you seeing the emergence of best practices with respect to cyber security and data security at hedge fund managers?

Johnson: Just like AML concerns, I think that hedge funds are really starting to appreciate their cyber security risks. Their platforms for data security are not nearly as large as those at big financial services firms, so I think it has taken some time for hedge fund managers to appreciate these risks. Today, the risk of economic espionage is real, and whether it's a nation state or a criminal organization, recent DOJ cases make plain that there are bad folks out there looking to hack into firms and obtain information that can be use to their financial advantage. Certainly the position a successful hedge fund manager has planned to take or has already taken with respect to stocks seems like a target for economic espionage. We are going to continue to advise our hedge fund manager clients about cyber security risks, and I think you will see investors caring more and more about these risks.

HFLR: As a deputy U.S. attorney, you managed the investigation and prosecution of individuals and entities responsible for structuring and promoting international tax shelters. Investment and other professionals at hedge fund managers are routinely pitched tax minimization products and strategies. What should the recipients of such pitches be looking for in distinguishing legitimate tax minimization strategies from illegal tax shelters?

Johnson: This is a complicated area, and one where certainly the hedge fund managers should consult experts, whether internally or externally. The difference between a legal and an illegal tax minimization strategy may not be apparent at the outset. But instead of having a list of questions to ask that might be incomplete, when there is a complicated tax strategy proposed, the manager should be consulting an expert to get advice and counsel on whether the strategy is legitimate or not. The manager needs to minimize the risk of becoming embroiled in an investigation of someone else that could harm its reputation.

HFLR: You saw a lot of fraud in your days as a prosecutor, across various industries, notably including financial services and healthcare. How, if at all, would your experience unraveling frauds in financial services and healthcare inform the investment or operational due diligence undertaken by hedge fund managers that invest in those industries? For example, are there one or two recurring but nonintuitive badges of fraud that should serve as warning signs to hedge fund managers that invest in healthcare companies, thus causing them to forgo an investment?

Johnson: First, if the analyst and the manager feel like something doesn't smell right, then it probably is not right. Put differently, if something appears to be too good to be true, it probably is. Your gut check is initially the best way to determine if an investment is right or wrong.

Second, often the concealment of information and the unwillingness to provide information or answer questions can be an indication that something is not right.

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