

Regulation and Compliance—Insider Trading

By now, everyone's heard about the Security and Exchange Commission's (SEC) criminal allegations against Raf Rajaratnam, his Galleon hedge funds, and executives at several major American firms. Aside from the spectacle of so many so high being brought so low, the case, even at this embryonic stage, is instructive for a number of reasons including the precise nature of the charges, the relief sought, the manner in which the evidence against the defendants was collected, and the likely implications for the hedge fund industry.

Insider Trading

Laws, regulations, rulings, and court cases imposing penalties and/or liability for "insider trading" are ultimately rooted in the common law of agency and principal. It has long been the case that where an agent acting in a fiduciary position of trust uses confidential information obtained from his or her principal for personal gain, the agent is liable to disgorge profits in favor of the principal.

After the stock market crash of 1929, Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934, aimed at controlling the abuses believed to have contributed to the crash. The 1934 Act addressed insider trading directly through Section 16(b) and indirectly through Section 10(b).

It is important to note that not all insider trading is considered illegal. Insiders (as defined by the 1934 Act) may trade securities of a company, so long as they are not in possession of non-public information at the time of the trade and properly disclose their trades with the SEC. This is not the type of insider trading at issue in the SEC's case against Rajaratnam.

Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. Insider trading violations may also include "tipping" such information, securities trading by the person "tipped," and securities trading by those who misappropriate such information.

Thus, Section 16(b) prohibits short-swing profits (profits realized in any period less than six months) by corporate insiders in their own corporation's stock, except in very limited circumstance. It applies only to directors or officers of the corporation and those holding greater

than 10 percent of the stock and is designed to prevent insider trading by those most likely to be privy to important corporate information.

Section 10(b) of the Securities and Exchange Act of 1934 makes it unlawful for any person "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, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." To implement Section 10(b), the SEC adopted Rule 10b-5, which provides, in relevant part:

It shall be unlawful for any person, directly or indirectly . . . ,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) 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 a security.

More recently, The SEC adopted new Rules 10b5-1 and 10b5-2 to resolve two insider trading issues where the courts have disagreed. Rule 10b5-1 provides that a person trades on the basis of *material nonpublic information* if a trader is "aware" of the *material nonpublic information* when making the purchase or sale. The rule also sets forth several affirmative defenses or exceptions to liability. The rule permits persons to trade in certain specified circumstances where it is clear that the information they are aware of is not a factor in the decision to trade, such as pursuant to a pre-existing plan, contract, or instruction that was made in good faith.

Rule 10b5-2 clarifies how the "misappropriation theory" applies to certain non-business relationships. Under this rule, even a person with no fiduciary relationship to an issuer may be liable for trading in the issuer's securities while in possession of information obtained in violation of a relationship of trust and confidence. For example, in one case involving the misappropriation theory, a securities trader, traded based on material non-public information about corporate takeovers obtained from two investment bankers, who had misappropriated the information from their employers.

In the typical insider trading case, an insider uses non-public information to profit on the sale of his or her employer's stock. The case against Rajaratnam is anything but typical.

The Charges

In its complaint against Rajaratnam, the SEC, relying on the provisions cited above, specifically alleges that “in connection with the purchase or sale of securities, have: (a) employed devices, schemes or artifices to defraud; (b) made untrue statements of material facts and omitted to state material facts necessary in order to make the statements made, in the light of the circumstances

Criminal charges for willful violations of Rule 10b-5 are punishable by up to 20 years in prison and fines of up to \$5 million for individuals and \$25 million for corporations. The SEC may also seek other relief including recovery of any illegal gains (or losses avoided) and payment of a civil penalty. The amount of a civil penalty can be up to three times the profit gained (or loss avoided) as a result of insider trading.

under which they were made, not misleading; and (c) engaged in acts, practices and courses of business which would operate as a fraud or deceit upon purchasers, prospective purchasers, and other persons.”

What makes this case particularly interesting is that Rajaratnam did not work for or have a direct fiduciary duty to the companies whose stock he traded on behalf of Galleon and others. In fact, one of his major sources was not even employed by the companies whose stock was traded. As the New York Times has reported:

“Indeed, the case against Mr. Rajaratnam and his co-defendants appears to be far more complicated than a simple exchange of cash for information.”

A close reading of the two criminal complaints filed so far, and an associated civil complaint filed by the Securities and Exchange Commission, suggests a web in which hedge fund managers, analysts, corporate executives, and consultants and other people outside Wall Street traded tips — sometimes for money, sometimes for other tips, and sometimes for little more than the promise of unspecified future favors.”

Another interesting aspect of this case is that because it is ultimately alleged to involve fraud, the SEC will be required to prove that the defendants acted willfully or at least recklessly. This goes to the defendants’ state of mind, which is notoriously difficult to establish.

Relief Sought

Insider trading may result in enforcement action by the SEC or in criminal prosecution by the Department of Justice. Criminal charges for willful violations of Rule 10b-5 are punishable by

up to 20 years in prison and fines of up to \$5 million for individuals and \$25 million for corporations.

The case against Rajaratnam et.al. is a civil enforcement action brought by the SEC.

The 1934 Act permits the SEC to bring suit against insider traders to seek injunctions, which are court orders that prohibit violations of the law under threat of fines and imprisonment. The SEC may also seek other relief including recovery of any illegal gains (or losses avoided) and payment of a civil penalty. The amount of a civil penalty can be up to three times the profit gained (or loss avoided) as a result of insider trading.

In the case against Rajaratnam et.al. the SEC is seeking permanent injunctions against each of the defendants, “enjoining them from engaging in the transactions, acts, practices, and courses of business alleged in this Complaint, disgorgement of all profits realized or losses avoided from the unlawful insider trading activity set forth herein, and civil penalties...” The civil penalty relief includes the treble damages authorized under the Insider Trading and Securities Fraud Enforcement Act of 1988. In addition, the Commission is seeking an order barring two of the named defendants from acting as officers or directors of any publicly-traded company at any time in the future.

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Methods Used to Obtain Evidence

Many insider trading investigations are initiated when stock exchanges send the SEC reports on traders who place profitable bets shortly before corporate announcements. The casual trader will be hard put to explain what prompted an uncharacteristic investment other than inside information. Hedge funds, on the other hand, can more plausibly attribute their windfalls to skill or chance.

To overcome that hurdle, the SEC began using data mining techniques about two years ago to sift hundreds of millions of electronic trading records known as blue sheets. By looking for patterns in the library of data, the SEC is able to identify traders who repeatedly made an inordinate number of apparently well-timed bets. Once investigators find a cluster of correlated trades, they tap other sources of information to unravel how traders obtained and shared tips.

Although the primary evidence against Rajaratnam wasn’t derived from data-mining, data-mining apparently alerted the SEC to suspicious trades, according to a Bloomberg press release.

Once alerted to the suspicious trades, investigators apparently recruited at least one informant and were able to obtain warrants for wiretaps. Such wiretaps require the demonstration of “probable cause,” that the law has been or is about to be violated. Existing laws allow the SEC to offer “bounties” to those who aid in insider trading investigations. However, it is unclear in this case, whether bounties were used.

As noted earlier, one of the most challenging aspects of insider trading cases is proving the requisite state of mind to commit fraud. Presumably, the SEC’s wire-tapped conversations of the defendants themselves will be relied on for this purpose. It’s difficult for a defendant to deny his or her own words.

What this Case Means

The SEC served notice earlier this year that it intends to pursue enforcement much more aggressively than in the recent past. For example, in February, it charged takeover advisers at UBS AG and Blackstone Group LP with taking part in an \$8 million insider-trading case. And, in June, the SEC filed a complaint against sub-prime lender Countrywide and its former CEO Angelo Mozilo involving contemporaneous **e-mails** expressing internal concern over the company’s lending practice while at the same time portraying a rosy picture to investors.

On a broader scale, cases like the one against Rajaratnam only add fuel to the fire as Congress considers broad regulation of the financial services industry including hedge funds. The Wall Street Journal has reported a run on Galleon funds in the wake of the complaint against it, and it’s likely the chill will extend to other hedge funds.

At the advisor level, The case points out the long reach of the laws and regulation at the SEC’s command, along with its impressive array of investigative and enforcement powers. It also demonstrates the importance of choosing one’s friends and contacts carefully, avoiding discussion of inside information, and especially avoiding passing on such information or relying on it when trading trades on one’s own account or on behalf of clients.

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