

## Hedge Funds Join “the CEO’s Brother-in-Law” as the Target of Insider Trading Cases

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Insider trading cases often have focused on “the CEO’s brother-in-law” or similarly situated individuals who used a tidbit passed along at Thanksgiving dinner to make a quick and easy personal profit. Today, hedge funds have joined “the CEO’s brother-in-law” as the target of insider trading cases. In the hedge fund context, charges are being based on a hedge fund employee’s collection of information as part of the employee’s job in trading the hedge fund’s assets, unlike the classic cases based upon receipt of an isolated “tip” outside of the work setting that will be used to generate profit for an individual.

The definition of insider trading has not changed since the days of the “evil brother-in-law.” Illegal insider trading occurs when a person in possession of material nonpublic information about a company trades in that company’s securities in violation of a duty of trust, and makes a profit or avoids a loss. That fiduciary duty or other duty of trust may be imputed. For example, in cases where a corporate insider “tips” a person about non-public information likely to have an effect on the company’s share price, the duty the corporate insider owes the company is now imputed to the “tippee,” and the tippee violates a duty to the company if the tippee trades on the basis of that information.

Most recently, the SEC has demonstrated its scrutiny of the trading activities of hedge funds by filing civil insider trading charges against four hedge funds, Galleon Management LP, New Castle Funds LLC, Spherix Capital LLC and S2 Capital Management LP. According to the Complaints, these hedge funds obtained material nonpublic information concerning market moving events such as earnings announcements, earnings and revenue forecasts, takeovers, and material contracts. The hedge funds then traded on the basis of that information, in violation of a fiduciary or other duty of trust, making purportedly over \$33 million in illegal profits.

In addition to the four hedge funds, two other companies and fifteen individuals have been named as defendants. The individuals’ job titles and affiliations are wide-ranging – a managing director at Intel Capital (a subsidiary of Intel Corp.), a director at McKinsey & Co., a Senior Vice President and Group Executive of IBM’s Systems and Technology Group, and a former industry analyst at Moody’s. Many of these defendants also face criminal charges.

The SEC’s investigation into the Galleon matter is continuing as evidenced by recent civil insider trading charges against one broker-dealer and eight individual defendants. This latest Complaint alleges that trades were made on the basis of inside information about corporate acquisitions, provided by an attorney who violated a duty of trust and confidence to his law firm and its clients. The individual defendants have wide-ranging job titles and affiliations – there is an associate at law firm Ropes & Gray LLP, a former Galleon trader who is currently a registered representative at Echotrade LLC and a trader at Incremental Capital LLC, a former registered representative and proprietary trader at Spectrum Trading, and a former trader at Lighthouse Financial Group, LLC who is currently a registered representative at Echotrade LLC and a trader at Incremental Capital. Criminal charges have also been brought against the eight individuals.

### The key evidence highlighted in the charging documents included:

- *Evidence tying the trades to “insiders”* - the source for inside information about Akamai was an Akamai executive; the source for the inside information about Clearwire was an executive at a company that was investing in Clearwire.
- *Evidence tying the trades to the “inside information”*:
  - ▶ One hedge fund trader asked another hedge fund principal, “if the two of us weren’t close to the company as we are, would you be long the [AMD] stock?” The hedge fund principal replied, “Yeah, no. I wouldn’t.” The hedge fund trader then said that she “wouldn’t of touch[ed] it with a ... 10-foot pole.”

- ▶ One hedge fund trader asked the Managing Director at her hedge fund, with respect to AMD stock, “Unless you were on the phone with [the AMD Executive] and had Moffat at your house last night, who the ... would be buying it honestly?”
- *Evidence of attempts to conceal the alleged insider trading*-- e.g. discussions about creating email trails to explain illegal trades, creating a “pattern of trading” in the stocks, and the alleged use of disposable cell phones that were destroyed after the tipped information was publicized.
- *Evidence of something of value being provided in exchange for the inside information*-- e.g., cash payments, inside information on other companies, trading on behalf of a tipper on the basis of inside information on other companies, and assistance in obtaining employment.
- *Evidence of knowledge of wrongdoing*:
  - ▶ One hedge fund trader told a tippee, “I swear to you in front of God ... You put me in jail if you talk. .... I’m dead if this leaks. I really am ... and my career is over. I’ll be like Martha ... Stewart.”
  - ▶ One hedge fund trader told the Managing Director at her hedge fund that she would “get a new cell phone and talk to [the AMD Executive] from there... I know I’m paranoid.” The Managing Director replied, “alright, well don’t keep talking about it on the phone. I’ll take care of it alright.”
  - ▶ One insider told a hedge fund principal, “I don’t like talking over cell phone on this.”

In the past, the headline of the “evil brother-in-law” was designed to ward off others who might be inclined to partake in seemingly quick and profitable trades for their personal gain. Here, however, hedge funds are in the business of trading in securities, and as such they must continue to collect market and company information in making their trading decisions. The key issue for hedge funds in the wake of the foregoing cases is ensuring that the information gathered to guide their trading activities does not cross the line into insider trading (and that they do not trade if they determine that they have come into possession of material inside information).

Some guidance can come be gleaned from the recent charges:

- The source of information is very important. Information obtained from people who owe a duty of trust to a company is more likely to cause a prosecutor to question whether there has been insider trading. Examples of such sources include senior employees, officers and directors of a public company who typically have inside information that could affect the company’s share price and professional consultants, such as lawyers, accountants, and investment bankers that have access to information about their publicly traded clients.
- The non-public nature of the information is a crucial factor. If you cannot think of a public source for the information under consideration, this is a red flag that it is the type of information that may raise the specter of a government investigation.
- A final key factor is whether the information was obtained through some form of “quid pro quo.” The fact that something of value was provided in exchange for specific information about a publicly traded company – whether it be money or another form of benefit (even other valuable information) -- may suggest to a prosecutor that “inside information” is being used to further stock trading.

Hedge funds should be sensitive to this issue, which is clearly at the forefront of current SEC and criminal enforcement efforts, and make certain they have robust policies and procedures in place with respect to insider trading.

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