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Client Alert

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Implications of the Rajaratnam Verdict for Hedge Funds and High Tech Companies

The May 11, 2011 conviction of Raj Rajaratnam, founder of Galleon Group, a New York-based hedge fund management firm, should serve as a further alert to hedge funds, high tech companies, and the professionals that serve them, of the heightened risks posed by the government's sweeping insider trading enforcement initiative and the need to mitigate those risks proactively.

Six Things You Need To Know

Among the lessons to be drawn from the government's ongoing focus on insider trading and the conviction of Rajaratnam are the following:

1. **More to come.** Although the Rajaratnam conviction marks the highwater mark, to date, of the government's crackdown on insider trading, it does not mark the end of that effort; there is more to come.

2. **Aggressive enforcement tactics.** Prosecutors will continue to use aggressive enforcement tactics, including wiretaps, search warrants and recordings made by cooperators, to build criminal insider trading cases.

3. **Not just criminal enforcement.** Where there is insufficient evidence to bring criminal prosecutions, regulators may instead seek sanctions through civil and administrative proceedings.

4. **Reputational damage.** Mere association with insider trading allegations visits severe reputational damage on the institutions involved and, especially in the case of hedge funds, can result in dissolution.

5. **Compliance counts.** The best way to avoid being swept into the enforcement net is to develop a rigorous insider trading compliance program, including a zero tolerance tone from the top, routine training, clear policies on using, or serving as part of, so-called "expert networks," and spot-checks on whether the compliance program is being followed.

6. **Be prepared.** Develop a plan and provide training on how to react should the Government knock on the door.

Background

Over the past 18 months, the United States Attorney's Office for the Southern District of New York ("SDNY") and the United States Securities and Exchange Commission ("SEC") have led a wide-ranging effort to enforce the laws that prohibit insider trading. To date, approximately 47 individuals have been charged

with insider trading crimes by the SDNY alone, and 36 have been convicted. Other components of the Department of Justice, state and foreign regulators have also been active in enforcing laws against insider trading – a trend which shows no signs of abating.

The Rajaratnam Case

Rajaratnam was accused of conspiring with multiple sources who provided him with confidential information about publicly traded companies. Rajaratnam allegedly used that information to make profits and/or to avoid losses totaling more than $60 million. What is noteworthy about this prosecution? First, over the defendant's objection, prosecutors successfully used wiretap evidence – a tactic usually reserved for organized crime investigations – in this most "white collar" of crimes. Second, the jury rejected the so-called "mosaic" defense that Rajaratnam's trading decisions were based on his legitimate piecing together of scraps of publicly available information contained in published analysts' reports and news stories rather than the confidential information that he received from co-conspirators. Third, jurors were not dissuaded from finding guilt by evidence of losing trades executed close in time to other profitable trades that were alleged to have been made with the advantage of material nonpublic information.

What's Next

Upcoming Trials and Proceedings

Rajat Gupta. One "fish" bigger than Rajaratnam is Rajat Gupta. On the eve of the Rajaratnam trial, the SEC brought an administrative proceeding against Gupta alleging that he engaged in insider trading when he breached his duties as a director of Goldman Sachs and Procter & Gamble by providing confidential information about those companies to Rajaratnam who, in turn, traded on that information. The Gupta case is significant because it may signal an increased willingness of the SEC to take advantage of its enhanced ability, under the Dodd Frank statute, to seek civil penalties in administrative proceedings. Those proceedings, which are conducted before an SEC Administrative law judge, and without a jury, give certain advantages to the SEC including limited discovery and rules that permit introduction of evidence that ordinarily would not be admissible in federal court.

Zvi Goffer et al. On May 16, a criminal trial commenced in the Southern District of New York in a case involving three founders of Incremental Capital. As in the just-tried Rajaratnam case, prosecutors have announced that they intend to rely on the results of wiretaps (which recently withstood legal challenges raised by defendants) and the testimony of cooperators, including a lawyer who allegedly provided Goffer with confidential information about transactions in which his firm was involved.[1] The allegations contained in the 14-count superseding indictment include numerous trades that the defendants made based on confidential information concerning then pending merger and acquisition transactions involving Hilton Hotels, Kronos, 3Com and Axcan. Six alleged co-conspirators,

[1] The author participated in the investigation of Goffer and his alleged co-conspirators while serving as a member of the Securities and Commodities Fraud Task Force of the U.S. Attorney's Office for the Southern District of New York. The author's law firm, Baker & McKenzie LLP, represents an individual in connection with an insider trading investigation related to Galleon.

three lawyers and three traders already have pleaded guilty and are awaiting sentencing.

Expert Networks. The Government has charged numerous individuals with conspiracy to commit securities fraud and other crimes arising out of the services provided by so-called “expert network” firms. Expert network firms arrange communications between individuals who are seeking market intelligence, including individuals who work at hedge funds, with expert consultants, including employees of companies with publicly-traded stocks. The Government has alleged that certain experts broke the law by providing to stock traders information that had been obtained in violation of fiduciary duties and other duties of trust and confidence owed to the publicly-traded companies to which the information related, and has alleged that others broke the law by receiving and trading on such information.

Daniel DeVore, formerly a Global Supply Manager at Dell, pleaded guilty to providing confidential information to the clients of three expert network firms, including hedge funds, in exchange for approximately $145,000. Manosha Karunatilaka likewise pleaded guilty to providing confidential sales and shipping information of Taiwan Semiconductor Manufacturing Company to expert network clients. Among the others charged are employees of Advanced Micro Devices, and Flextronics International. Winifred Jiau, an expert consultant, is scheduled to go to trial on June 1. Jiau is accused of collecting material nonpublic information (including earnings, revenue, gross margins and other financial information) from employees of public companies, including Marvell Technology Group and NVIDIA, and providing that information to hedge fund employees in exchange for direct payments or soft dollar payments made to the expert network firm for which Jiau worked.

The prosecutions related to expert networks likely will further test the effectiveness of the “mosaic” defense and may redefine the boundaries of sources on which analysts and traders safely may rely in gathering information about securities they intend to trade.

Rajaratnam Sentencing. Rajaratnam faces a statutory maximum sentence of 205 years in prison. Although his sentence no doubt will be far shorter than that, recent history shows that judges have been meting out stiff sentences in insider trading cases to send a strong deterrent message to others.[2] For example, in 2010, Judge Richard J. Sullivan, in sentencing former Jeffries hedge fund manager Joseph Contorinis to 6 years in a case involving profits and avoided losses of $7 million, stated, “This is a crime that does damage to the national economy; it’s very important to send a message through the sentence imposed on you; you will become a poster child for what happens.” Likewise, in 2008, Judge Robert Patterson, in sentencing Hafiz Naseem (formerly an investment banker at Credit Suisse) to 10 years for tipping a co-conspirator who netted $8 million but who received nothing himself, said, “This crime has to be deterred and it has to be deterred by a strict sentence. I think it’s going on too much and people who do it have to realize that they’re going to pay.” Those defendants charged in connection with the Rajaratnam investigation who have pleaded guilty and have been sentenced have, however, received far lower sentences, including: Mark Kurland (New Castle Fund) 27 months; Ali Hariri (Atheros

[2] According to the Rajaratnam prosecutors, application of the advisory U.S. Sentencing Guidelines would result in a sentence of between fifteen and one-half and nineteen and one-half years.

Communications, Inc.) 18 months; Robert Moffatt (IBM) 6 months. Many others are awaiting sentencing.

Government Tactics

The Government appears to be committed to using aggressive tactics in investigating insider trading and other white collar crimes. Although the Government has long relied on cooperators to record calls in securities fraud investigations, wiretapping previously had been used only rarely. In a speech last Fall to the New York City Bar Association, Preet Bharara, the United States Attorney for the Southern District of New York, made clear that the Government intends to continue to use all the tools at its disposal:

> The public correctly wants us to use every tool to thwart criminals and prevent fraud. And that is exactly what we are doing. We will use every aggressive and innovative method available to address many of the unprecedented challenges that we face today.
>
> And especially when sophisticated business people begin to adopt the methods of common criminals, such as the use of anonymous cellphones, we have no choice but to treat them as such. To use tough tactics in these circumstances is not being heavyhanded; it is being even-handed.[3]

How Should Your Business Respond?

How should your business respond to the government's ongoing insider trading investigations? Among the categories of businesses that are under scrutiny, or that have been affected by the investigations, are hedge funds, high technology and pharmaceutical companies. Some suggested prophylactic steps include the following:

Hedge Funds

1. Review your compliance program, particularly your policies and procedures designed to prevent insider trading. Assess whether sufficient resources have been devoted to compliance.

2. Make sure that the use of expert networks or consultants is carefully controlled. Although the use of such resources is not *per se* illegal, it is a practice that is under scrutiny. A hedge fund should take appropriate steps to ensure that any information it receives is not material nonpublic information, including conducting due diligence on the source of the information.

3. Provide regular training on insider training geared to the investment strategy followed by the fund(s). Make sure that traders understand the risk to the firms reputation and existence were it to be associated with insider trading or any other illegal activity.

4. Prepare for the unexpected. Develop protocols and train employees with respect to: (a) securing information (hard-copy and digital) in the event

[3] October 20, 2010 speech of Preet Bharara to the New York City Bar Association.

the fund receives a subpoena; (b) responding to a search warrant; and (c) responding to approaches by law enforcement.

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High Tech or Pharmaceutical Companies

Criminal and civil charging documents reveal that many current insider trading cases involve the stocks of high tech or pharmaceutical companies. Because there appears to be a special premium for confidential information about such companies, they should take special steps to protect that information.

1. Review the categories of confidential information received and generated by the company and determine who has access to that information.

2. Consider modifying procedures and responsibilities to limit access to confidential information.

3. Review policies concerning the confidentiality of corporate information (including information received from suppliers and customers). Provide general training to all employees, and enhanced training to those individuals with regular access to financial and other highly material information.

4. Review policies concerning outside employment, and consider explicitly prohibiting employees from engaging in any unauthorized consulting.

* * *

Given the intensity with which regulators are attempting to clamp down on insider trading, and the prosecutors' recent success in the Rajaratnam case, now is the time to make sure that your company has in place appropriate compliance programs to prevent and detect the involvement of your employees in violations of the securities laws before the government knocks on your door.

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