



SEC vs Hedge Funds: “un partout, balle au centre” (1/3)

In light of the recent insider trading cases revealed by the SEC, investors' confidence in hedge funds has once again been challenged.

Before delving into the recent *SEC v. Galleon Management, LP et al.* complaint, it is important to define what insider trading is. According to a recent Katten Muchin Rosenman LLP newsletter:

“Insider trading” is not defined in the federal securities laws, but insider trading laws have developed through SEC and court interpretations of Section 10(b) of the Securities Exchange Act of 1934, as amended, prohibiting use of a “deceptive device” and the anti-fraud provisions of Rule 10b-5. Insider trading is considered a “deceptive device” and generally includes using material non-public information to trade in securities either personally or on behalf of another (whether or not one is an “insider”) or communicating material non-public information to others. The laws pertaining to insider trading encompass (a) trading by an insider while in possession of material non-public information; (b) trading by a non-insider while in possession of material non-public information, where the information either was disclosed to the non-insider in violation of an insider's duty to keep it confidential or was misappropriated; and (c) communicating material non-public information to others.

It is also worthwhile to note that the SEC recently published on its website a “Spotlight on Insider Trading”, in which they released data on enforcement initiatives as well as various remarks made by their representatives on insider trading. In its publication, the SEC referred to illegal insider trading as being:

“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.”

The SEC also published a track record of enforcement actions for insider trading. It is shown in the following graph:



Since March 2009, several SEC representatives have made it clear that the Commission is undertaking initiatives to sanction hedge funds and their investment advisers for unlawful activities. The SEC even announced the creation of a special Hedge Fund Working Group that will address issues like: “(i) possible manipulation, abusive short selling and collusion; (ii) valuation concerns with respect to illiquid assets; and (iii) potential insider trading in a host of circumstances, including prior to mergers and acquisitions and in the credit derivatives market as well as other issues arising in investigations relating to hedge funds.”

In October 2009, Mr. Robert Khuzami, the acting SEC Enforcement Director, declared that:

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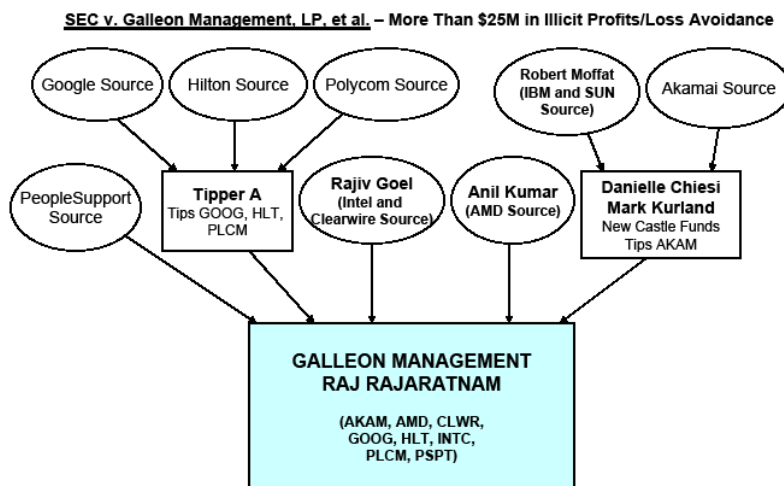


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“[...]. We at the SEC are committed to pulling back the curtain on hedge fund operations and taking a close look at their activity. We are developing a variety of initiatives to do that involving greater specialization and expertise, improved technological tools to track and analyze trading, better coordination among regulators and law enforcement, new legislative initiatives, and other means to address these areas.”

It’s on this backdrop that on October 16th, 2009, the SEC charged billionaire Raj Rajaratnam and his New York-based hedge fund advisory firm Galleon Management LP with engaging in a massive insider trading scheme that generated more than \$25 million in illicit gains. The SEC also charged six others involved in the scheme, including senior executives at major companies IBM, Intel and McKinsey & Company.

The following chart provides an overview of Rajaratnam scheme:



Source: U.S. Securities and Exchange Commission

“Tipper A” in the above chart has since been identified as being Ms. Roomy Khan. Ms. Khan is known to have had a long history in tipping Galleon since at least 1998 when she was employed at a publicly traded company (later identified as Intel). According to prior SEC filings, Ms. Khan sent at that time, to an unidentified representative of Galleon Management Inc., backlog and billing reports, product pricing and sales data on Intel micro-processors for the first and second quarter of the year. Khan later pleaded guilty in April 2001 to one count of wire fraud and was sentenced the following year to a six month home detention, fined \$30,000 and ordered to pay \$120,000 in restitution. Interestingly enough, Galleon was not charged for any wrongdoing in that case. After the Intel incident, Ms. Khan worked at Galleon for a period of time and later approached Rajaratnam to return to Galleon in 2005, but he did not rehire her. According to the recent SEC’s complaint, the SEC alleges that Khan provided insider information to Rajaratnam in 2006 and 2007, who acted thereon. According to Rommy Khan’s LinkedIn profile, she is currently a consultant to Trivium Capital, another investment manager based in New York.

It is worth noting that both Galleon Management LP and New Castle Funds LLC (the second fund manager involved in the scheme) are both investment advisers registered with

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the SEC since January 2006 and October 2008, respectively. Both firms have compliance and code of ethics manuals, as well as a compliance officer which is supposed to enforce the firms' compliance programs. In both cases, the compliance officers assumed the role of Chief Financial Officer.

In light of the above, the major questions surrounding Galleon's case are: Why insider trading?, Why hedge funds? and Why now? If we randomly look at the historical enforcement actions by the SEC for insider trading, we can note that a very high percentage of the defendants are individuals and not institutions. In finance, the key factor to consider before taking an investment decision is the potential upside compared to the potential downside. In the case of insider trading, the potential to pocket \$25 million in profit based on a few tips compared to the risk of being caught and fined for an individual looks quite attractive. However, one can ask what is the rationale for a hedge fund, or another financial institution managing billions of dollars, to generate a profit of \$25 million for its clients of which only a part of it will become a benefit for the firm when the potential downsides are lengthy legal battles and a serious damage to a firm's reputation which could ultimately lead to its closure. Moreover, as mentioned above, both firms had in place compliance procedures which were supposed to deter employees from performing unlawful trading.

We therefore have to consider two alternatives: (1) the profit from insider trading activity at Galleon is much higher than \$25 million and the company's alpha was based exclusively on insider tips; or (2) the SEC found a good “bouc-emmisaire” to denounce a reprehensible known practice, and to make an example of that person, as well as score a success on hedge funds in order to support the Commission's push for stronger regulations in the hedge fund industry.

From the SEC's public remarks, it appears that the Commission SEC is endorsing the first alternative. Mr. Robert Khuzami said:

“What we have uncovered in the trading activities of Raj Rajaratnam is that the secret of his success is not genius trading strategies. He is not the astute study of company fundamentals or marketplace trends that he is widely thought to be. Raj Rajaratnam is not a master of the universe, but rather a master of the rolodex.”

[...]

“He cultivated a network of high-ranking corporate executives and insiders, and then tapped into this ring to obtain confidential details about quarterly earnings and takeover activity.”

As attractive as the first alternative appears, we tend to prefer the second alternative. Indeed, we believe that with this pending *Galleon* case the SEC is trying to set the tone for the hedge fund industry. Inasmuch as it appears to be singling out a hedge fund, we must admit that the SEC's action allows to identify rotten apples. However, we believe that insider trading is not a hedge fund specific problem, but rather an industry whole problem. Another positive aspect of the SEC's clamp down on insider trading is the reduction of a risk for investors in hedge funds which is very difficult to identify. Moreover, by bringing the issue of insider trading to the public eye, it could allow the SEC and other regulatory bodies to make to a strong case for regulatory changes.

Lastly, in light of the pending *Galleon* case, it seems that compliance programs and the use of a compliance officer are insufficient measures to ensure that Fund representatives or employees respect the law. Also, the extra control measures that the SEC are adopting, i.e. enforcement actions, will assuredly have a deterrent effect on hedge fund managers who look to prove their skills through good networking versus hard work, as in the pending *Galleon* case.

Sources: The SEC Spotlight on Insider Trading is available at : <http://www.sec.gov/spotlight/insidertrading.shtml>, <http://www.businessinsider.com/roomy-khan-named-as-the-nark-in-galleon-bust-2009-10>, The SEC complaint is available at : <http://www.sec.gov/litigation/complaints/2009/comp21255.pdf>

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