



JONES DAY
COMMENTARY

***GALLEON* VERDICT ANNOUNCED: INSIDER TRADING REMAINS A TOP ENFORCEMENT PRIORITY AMONG REGULATORY AUTHORITIES**

In the closely watched *Galleon* trial, hedge fund billionaire Raj Rajaratnam has now been convicted of all 14 conspiracy and securities fraud charges he was facing over alleged insider trading. Notably, during the seven-week trial in the Southern District of New York, the largest hedge fund insider trading case to date, the government presented evidence of many wiretapped conversations between Rajaratnam and his alleged insider sources. The secretly taped telephone calls were played for the jury in the courtroom during the trial, and over the course of deliberations, the jury asked to hear them again. This significant victory for the government will undoubtedly lead prosecutors to be more aggressive in their use of wiretap evidence in securities investigations and will encourage civil and criminal authorities to coordinate closely in investigations.

As United States hedge fund and M&A activity continues to play a dominant role in today's markets, insider

trading remains a top enforcement priority for regulatory authorities. In 2010, for example, the SEC ramped up its investigatory efforts by creating specialized units to target insider trading matters and matters involving hedge funds. In the current enforcement environment, which includes the aftermath of the financial crisis and numerous recent probes involving insider trading, it is important for investment bankers, hedge fund executives, lawyers, analysts, and others in the mergers and acquisitions and hedge fund industries to understand that their performance is ever more scrutinized by the SEC and other government agencies.

Regulatory authorities have delivered increasingly clear messages regarding the renewed focus on hedge fund and M&A insider trading. In 2010, the SEC brought more than 50 cases involving insider trading.¹ In the context of discussing the SEC's recent significant cases, Robert Khuzami, the SEC Director

¹ See Select SEC and Market Data: Fiscal 2010 Report, at 8-9.

of the Division of Enforcement, said that the SEC is canvassing all hedge funds for aberrational performance as it “continue[s] to vigorously enforce insider trading laws.”² And in the M&A insider trading area, Khuzami articulated the current regulatory climate: “Confidential deal information is not just another commodity that can be traded for profit.”³ Marc Berger, deputy chief of the Securities and Commodities Task Force at the U.S. Attorney’s Office for the Southern District of New York, said in April 2011 that insider trading was one of six of his task force’s top priority areas.⁴

As part of the Division of Enforcement’s recent, significant restructuring, it has created nationwide specialized units to concentrate on high-priority areas of enforcement including insider trading and hedge funds. One such unit is the Market Abuse Unit, tasked with targeting large-scale insider trading, market manipulation schemes, and high-volume and computer-driven trading strategies.⁵ The Market Abuse Unit has a staff of about 50 staff attorneys and specialists across nine SEC offices.⁶ The Asset Management Unit, staffed with 60 attorneys and specialists, is tasked with overseeing hedge funds and investment advisers.⁷

Daniel Hawke, the national unit chief of the SEC’s Market Abuse Unit, said the SEC is using targeted investigative approaches such as pattern detection and automated trading data analysis to ascertain the relationships and patterns among traders, institutions, and large-scale trading networks that suggest wrongdoing.⁸ Khuzami said that one of the Division’s upcoming priorities in the market abuse area is “to understand and analyze new trading technologies

such as high-frequency and algorithmic trading, data feed latency issues, and large volume trading, as well as systemic insider trading and manipulation schemes.”⁹ As a result, the Division of Enforcement is establishing an Analysis and Detection Center with specialists who are experts in analyzing and structuring complex trading data to work with investigative staff in the Market Abuse Unit.¹⁰

RECENT HEDGE FUND INSIDER TRADING CASES

Some of the key recent hedge fund insider trading enforcement cases that appear to be part of a continuing trend include:

Galleon. The matter the jury just decided began in October 2009, when the SEC charged the multibillion-dollar New York hedge fund advisory firm Galleon Management LP and its founder and manager Raj Rajaratnam with engaging in an insider trading scheme that generated more than \$53 million in insider gains and avoided an additional \$9.9 million in losses.¹¹ Over the course of its investigation, the SEC also charged at least 25 other individuals and entities involved in the scheme, including three hedge fund managers, many of whom have reached settlements with the SEC. In November 2010, for example, the SEC charged hedge fund manager Thomas C. Hardin with insider trading in an action related to the *Galleon* investigation.¹² Khuzami noted that the charges against Hardin “demonstrate the SEC’s ongoing crackdown on insider trading on Wall Street” and that the SEC would take “aggressive action” against hedge

2 Robert Khuzami, SEC Dir. of Div. of Enforcement, Speech by SEC Staff: Remarks at SIFMA’s Compliance and Legal Society Annual Seminar (Mar. 23, 2011).

3 Press Release, SEC, “SEC Charges Former Employees of Global Firms in Serial Insider Trading Scheme” (Dec. 16, 2009).

4 See Joshua Gallu, “U.S. Prosecutors Probe High-Frequency, Algorithmic Trades,” BLOOMBERG (APR. 29, 2011).

5 See Nick Paraskeva, “SEC Market-Abuse Chief Takes Trader-Based Approach,” REUTERS (FEB. 22, 2011).

6 See *id.*

7 See *id.*

8 See *id.*

9 Remarks of Robert Khuzami, *supra* note 2.

10 See SEC web site, Analysis and Detection Center, Market Abuse Unit, Division of Enforcement, http://www.sec.gov/jobs/jobs__adc.pdf (last visited Apr. 28, 2011).

11 See *SEC v. Galleon Management, LP, et al.*, Civil Action No. 09-CV-8811 (S.D.N.Y.), Litig. Release No. 21255 (Oct. 16, 2009). The U.S. Attorney’s Office simultaneously filed criminal charges against Rajaratnam and other individuals allegedly involved in the insider trading scheme.

12 See *SEC v. Thomas C. Hardin*, Civil Action No. 10-CV- 8600 (S.D.N.Y.), Litig. Release No. 21740 (Nov. 15, 2010).

funds and other market professionals that illegally trade on inside information.¹³

The SEC alleged that Rajaratnam tapped into his network of business associates and friends to obtain confidential information and insider tips about corporate earnings or takeover activity at several companies.¹⁴ According to the SEC, he then used the inside information to illegally trade on behalf of Galleon. In a statement about the *Galleon* case, Khuzami said, “The involvement of hedge funds and their principals, consultants, and portfolio managers, in this case is of particular concern.”¹⁵

In early March 2011, a year and a half after federal prosecutors first filed charges, Rajaratnam went on trial in the U.S. District Court for the Southern District of New York in the criminal phase.¹⁶ After a seven-week trial, the jury convicted Rajaratnam on all 14 of the securities fraud and conspiracy charges the Department of Justice brought against him.¹⁷ Facing up to 25 years in prison, Rajaratnam was released on \$100 million bail, and his sentencing is scheduled for July 29, 2011.¹⁸

Cutillo. Shortly after the *Galleon* case was brought, regulatory authorities filed charges in another insider trading ring involving hedge funds. In November 2009, the SEC charged attorney Arthur Cutillo and another attorney, Jason Goldfarb, in a \$20 million insider trading scheme that included a number of hedge fund traders who received inside information.¹⁹

The SEC alleged that the attorneys had gained access to confidential information in advance of four corporate acquisitions or bids involving clients of the law firm where they worked and illegally tipped the inside information to hedge fund employees in exchange for kickbacks.²⁰ Notably, one of the tippee hedge fund employees worked at Galleon Management LP. Some of the defendants have pleaded guilty, and civil settlements have been executed.

Primary Global Research LLC. In February 2011, the SEC charged a New York-based hedge fund and four portfolio managers and analysts for causing their hedge funds to trade on illegal tips from technology company employees moonlighting as consultants at an “expert network” firm, Primary Global Research LLC (“PGR”).²¹ The SEC alleges that the technology employees who also served as PGR consultants obtained access to material nonpublic information about sales, earnings, or performance data at various public technology companies. They shared the information with PGR’s hedge fund clients and, in return, received cash compensation from PGR. According to the SEC, the scheme netted more than \$30 million from trades based on material nonpublic information about such technology companies. Some of the defendants are in plea talks with the government.²² The SEC was not alone in conducting this investigation; it worked closely with the U.S. Attorney’s Office and the FBI.²³

13 Press Release, SEC, “SEC Brings Additional Charges in Its Ongoing Investigations Into Two Previously Identified Insider Trading Rings” (Nov. 12, 2010).

14 See *Galleon SEC Litig.* Release No. 21255, *supra* note 11.

15 Robert Khuzami, SEC Dir. of Div. of Enforcement, Speech by SEC Staff: Remarks at Press Conference (Oct. 16, 2009).

16 That same month, the SEC charged Rajat Gupta, a former board member of Goldman Sachs, for illegally tipping Rajaratnam with inside information about earnings at both firms as well as an impending \$5 billion investment by Berkshire Hathaway. The case brought against Gupta represented the SEC’s first use of its new authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act to obtain penalties in an Administrative Proceeding against persons not associated with a regulated entity. During the *Galleon* trial, the government called Lloyd Blankfein, CEO of Goldman Sachs, to testify regarding whether Gupta gave confidential information arising out of Goldman Sachs board meeting discussions to Rajaratnam. Gupta has brought the SEC’s authority under Dodd-Frank into question by filing a lawsuit in March 2011 against the SEC over the action against him, claiming it bars him from a jury trial. He also denied any wrongdoing through his lawyer.

17 See Christie Smythe, “Galleon Founder Guilty On All Counts,” *Law360* (May 11, 2011).

18 See *id.*

19 See *SEC v. Arthur J. Cutillo, et al.*, Civil Action No. 09-09208 (S.D.N.Y.), Litig. Release No. 21283 (Nov. 5, 2009).

20 See *id.*

21 See *SEC v. Mark Anthony Longoria et al.*, Civil Action No. 11-CV- 0753 (S.D.N.Y.), Litig. Release No. 21844 (Feb. 8, 2011).

22 See Kara Scannell, “Former manager in talks to plead guilty,” *FIN. TIMES* (MAR. 1, 2011).

23 See Robert Khuzami, SEC Dir. of Div. of Enforcement, Speech by SEC Staff: News Conference Remarks (Feb. 8, 2011).

RECENT M&A INSIDER TRADING CASES

Some of the recent key M&A insider trading enforcement cases include:

Kluger/Bauer. On April 6, 2011, the SEC charged Matthew Kluger, a corporate attorney, and Garrett Bauer, a professional stock trader, with engaging in an insider trading scheme that generated illicit profits totaling at least \$37 million.²⁴ The U.S. Attorney's Office for the District of New Jersey filed a parallel criminal action against Kluger and Bauer.²⁵ The SEC alleged that as early as 1994 and, after a hiatus, again between April 2006 and March 2011, Kluger accessed his law firm employers' internal document management systems to unearth nonpublic information in advance of at least 11 mergers and acquisitions involving clients of the law firms.²⁶ He then tipped a middleman, Kenneth Robinson—a mutual friend of Kluger's and Bauer's—who passed the corporate secrets to Bauer.²⁷ Bauer in turn placed trades on the confidential information on behalf of Kluger, Robinson, and himself in advance of announcements for at least nine deals.²⁸ Robinson also placed trades directly on some of the deals for the benefit of himself and Kluger only.²⁹ At the time the SEC filed the charges, it alleged that Bauer's trades generated nearly \$32 million in illegal profits; about a week later, as the investigation continued, prosecutors announced they thought the scheme generated profits exceeding \$37 million.³⁰

According to the SEC, Bauer repeatedly withdrew cash from his bank accounts and gave kickbacks of hundreds

of thousands of dollars to the middleman, who delivered at least \$500,000 to Kluger for tipping the information.³¹ Bauer and the middleman “understood” that gambling could provide a cover story for the cash disbursements that Bauer would pay Kluger and the middleman as their share of the insider trading.³² Acknowledging Kluger's, Bauer's, and the middleman's deliberate strategies to conceal their allegedly fraudulent scheme, Khuzami said in a statement that Kluger and Bauer “plotted to fly under law enforcement radar by using disposable phones to hide their communications, cash withdrawals to obscure the flow of tainted money, and a middleman to conceal Kluger as the secret source of inside information. Now, those same schemes and devices serve only to make it clear beyond any doubt that Kluger and Bauer were involved in an illegal scheme.”³³

Kluger and Bauer were released on bail by agreeing to post bonds of \$1 million and \$4 million, respectively.³⁴ Robinson signed a plea agreement admitting most of the charges alleged in the criminal complaint brought against him.³⁵ He cooperated with the government investigation by secretly recording his conversations with Kluger and Bauer and has continued to share with investigators information about the deals traded on throughout the scheme.³⁶ In addition to the SEC and the U.S. Attorney's Office, multiple regulatory authorities, including the IRS, FBI, FINRA, and the Options Regulatory Surveillance Authority, are working together in the ongoing investigation into this alleged insider trading scheme.³⁷

24 See *SEC v. Matthew H. Kluger and Garrett D. Bauer*, Case No. 11-CV-1936, Litig. Release No. 21917 (D. N.J. Apr. 6, 2011).

25 See Press Release, DOJ, “Attorney and Trader Arrested, Charged With Trading On Inside Information Stolen From Three Preeminent Law Firms” (Apr. 6, 2011).

26 See Complaint, *SEC v. Matthew H. Kluger and Garrett D. Bauer*, Case No. 11-CV-1936 (D. N.J. Apr. 6, 2011).

27 See *id.*

28 See *id.*

29 See *id.*

30 See *id.*; David Voreacos, “Lawyer Kluger Wins Bail as U.S. Insider-Trading Probe Expands,” BLOOMBERG (APR. 16, 2011).

31 See Kluger SEC Litig. Release No. 21917, *supra* note 24.

32 See Complaint, *SEC v. Kluger*, *supra* note 26.

33 See Press Release, SEC, “SEC Charges Corporate Attorney and Wall Street Trader in \$32 Million Insider Trading Ring” (Apr. 6, 2011).

34 See Voreacos, *supra* note 30.

35 See David Voreacos, “Kenneth Robinson Admits to 17-Year Insider-Trading Scheme,” BLOOMBERG (APR. 11, 2011).

36 See *id.*

37 See Kluger SEC Litig. Release No. 21917, *supra* note 24; Press Release, DOJ, *supra* note 25.

McClellan/McClellan. In November 2010, the SEC charged husband and wife Arnold and Annabel McClellan with engaging in a multimillion dollar international insider trading scheme.³⁸ According to the SEC, Arnold McClellan, in connection with his position as a partner at a large accounting firm and as the head of one of its regional M&A teams, obtained highly confidential mergers and acquisitions information involving his firm's clients.³⁹ Among the confidential acquisitions were aQuantive Inc., a digital advertising and marketing company acquired by a large technology company in 2007, and Getty Images Inc., a licenser of visual content, including photographs, acquired by a private equity firm in 2008.⁴⁰

The McClellans then allegedly provided advance notice regarding at least seven client acquisitions to James and Miranda Sanders, Annabel's relatives in London.⁴¹ The SEC alleged that James Sanders, a trader at a London-based derivatives firm, used the information to take financial positions in U.S. companies that were targets of acquisitions by Arnold McClellan's accounting firm's clients.⁴² The insider trading scheme among these relatives reaped illegal profits of approximately \$3 million, to be split 50/50 between James Sanders and Annabel McClellan.⁴³

Sanders also allegedly tipped colleagues at his derivatives firm with information in advance of the corporate acquisitions, earning tippees and clients at his trading firm approximately \$20 million by trading on the inside information.⁴⁴ The U.K. Financial Services Authority ("FSA") brought charges against James and Miranda Sanders and some of James

Sanders's colleagues whom he had tipped with the nonpublic information.⁴⁵

In addition to the FSA, the SEC also worked with the FBI and the U.S. Attorney's Office for the Northern District of California, which filed a parallel criminal action against Annabel McClellan only.⁴⁶ On April 7, 2011, Annabel pleaded guilty to a criminal obstruction charge for making false statements in connection with the SEC investigation. Facing a maximum of five years in prison and a \$250,000 fine for the crime, Annabel will be sentenced on September 20, 2011.

Garcia/Sanchez. In August 2010, the SEC charged Juan Jose Fernandez Garcia and Luis Martin Caro Sanchez, two residents of Spain, with insider trading after they made about \$1.1 million in illegal profits by trading in advance of the public announcement of a \$38.6 billion cash tender offer by BHP Billiton, the world's largest mining company, to acquire Potash Corp. of Saskatchewan Inc., a large producer of fertilizer minerals.⁴⁷ In conjunction with the charges, the SEC obtained an emergency court order to freeze the traders' assets, grant expedited discovery, and prevent Garcia and Sanchez from destroying evidence.⁴⁸

The SEC alleged that Garcia gained access to confidential information about the tender offer in connection with his role as head of a research arm at a banking group advising BHP on the bid.⁴⁹ Garcia and Sanchez allegedly used the confidential information to purchase more than 600 call option contracts for stock in Potash just days before BHP's bid was made public on August 17, 2010.⁵⁰ According to the

38 See *SEC v. Arnold McClellan and Annabel McClellan*, Case No. CV-105412, Litig. Release No. 21758 (N.D. Cal. Nov. 30, 2010).

39 See *id.*

40 See *id.*

41 See *id.*

42 See *id.*

43 See *id.*

44 See *id.*

45 See *id.*

46 See Press Release, DOJ, "San Francisco Resident Indicted For Obstructing SEC Insider Trading Investigation" (Nov. 30, 2010).

47 See Press Release, SEC, "SEC Freezes Assets of Two Traders in Spain for Insider Trading Around Public Announcement of BHP Acquisition Bid" (Aug. 24, 2010).

48 See *id.*

49 See *id.*

50 See *id.*

SEC, immediately after BHP's offer was announced, Garcia and Sanchez sold all of the option contracts and gained illicit profits of nearly \$1.1 million.⁵¹ In a statement about the case, Hawke said, "When abusive market practices occur, as in the case against Garcia and Sanchez, we will act swiftly and decisively to deny wrongdoers the profits of their illegal activity."⁵² In late April 2011, without admitting or denying the allegations against him, Garcia agreed to settle the insider charges with the SEC in an amount exceeding \$625,000. The SEC's charges against Sanchez remain pending.

CONCLUSIONS

Given the current enforcement environment, investment bankers, hedge fund employees, lawyers, analysts, consultants, and others in the M&A and hedge fund industries should understand the far-reaching effects of the SEC's increasing scrutiny of trading activity. It is important to remain familiar with the issues and outcomes arising out of the recent hedge fund and M&A insider trading cases, including Galleon, Cutillo, Primary Global Research, Kluger/Bauer, McClellan/McClellan, and Garcia/Sanchez, in order to understand the lessons to be learned and applied to business practices going forward. For example, in the *Galleon* case, the hedge fund disintegrated after Rajaratnam was arrested, and he faces up to 25 years in prison for his actions. And although the entities that hired the alleged M&A insider traders have not been accused of wrongdoing, they will still have to confirm they have adequate controls in place to deflect future insider trading or employee misconduct.

While the use of wiretaps will likely be a significant issue on appeal, no doubt the *Galleon* jury verdict will embolden the criminal authorities' use of wiretaps in white collar prosecutions. In light of close collaboration between the SEC and the criminal authorities, this wiretap information will most certainly become a part of the SEC's related investigations as well. All of this heightens the issues for entities and individuals caught up in the government's potentially widening net of insider trading investigations and prosecutions.

To avoid being the next company, law firm, or financial institution implicated in an insider trading investigation, it is important to have compliance programs and policies that adequately address insider trading risk, with the following key attributes, among others:

- Controls to prevent, detect, and deter insider trading conduct;
- Effective employee training;
- Written guidelines concerning the receipt of material nonpublic information and the maintenance of its confidentiality;
- Robust clearance procedures for investments by employees for their own accounts;
- An anonymous hotline for reporting violations; and
- Comprehensive procedures for investigating misconduct.

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⁵¹ See *id.*

⁵² See *id.*