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Insider Trading

Katten Muchin Rosenman Hosts Program on "Infected Hedge Funds" Highlighting Rights and Remedies of Investors in Hedge Funds Whose Managers are Accused of Insider Trading or of Operating Ponzi Schemes

By Jennifer Banzaca

The discovery, duration and depth of Ponzi schemes and insider trading rings uncovered during the last two years have altered, to a degree, the assumptions of institutional investors. While investors do not presume that every hedge fund manager is engaged in illicit activity, they have expanded their due diligence checklists to include questions intended to identify and avoid bad actors. Investors also realized that due diligence can never be perfect, and accordingly, have refocused on the legal rights and remedies available to parties invested with managers that are or are alleged to be operating Ponzi schemes or engaged in insider trading. See "Hedge Funds in the Crosshairs: The Law of Insider Trading in an Active Enforcement Environment," The Hedge Fund Law Report, Vol. 3, No. 7 (Feb. 17, 2010).

In recognition of these abiding concerns among institutional investors, and the concomitant interest among hedge fund managers in demonstrating their commitment to compliance, law firm Katten Muchin Rosenman LLP hosted a seminar on March 16, 2010 titled "Infected Hedge Funds: Rights and Remedies." The Katten Partners that served as panelists discussed various relevant topics, including the categories of claims and defenses available to investors in hedge funds whose managers are accused of Ponzi scheme operation or insider trading; differences in remedies available to direct and indirect investors; the SEC's new enforcement initiatives and cooperation measures (including cooperation agreements, deferred prosecution agreements and non-prosecution agreements); and prophylactic measures hedge fund managers can take to prevent accusations of insider trading or running a Ponzi scheme. This article describes in detail the most relevant topics discussed and points made at the Katten seminar.

Ponzi Scheme Risks, Rights and Remedies

Anthony Paccione, Partner and Co-Chair of the Litigation and Dispute Resolution Practice in Katten's New York office, explained that your risks, rights and remedies as an investor in a hedge fund whose manager is accused of running a Ponzi scheme will depend largely on whether you invested directly in the fund or indirectly through a feeder fund.

Direct Investors

Direct investors have advantages such as affirmative claims for recovery. Direct investors may be able to file insurance claims with the Securities Investor Protection Corporation, the entity that administers SIPA. Claims can sometimes be made directly against the investment manager and, possibly, against secondary actors that may have aided and abetted the scheme, such as accountants and advisers. On SIPA procedure, see "Can the Madoff Trustee Recover Disbursements of Fictitious Investment Returns Made to 'Remote' Transferees?," The Hedge Fund Law Report, Vol. 2, No. 21 (May 27, 2009).

"As a direct investor, you may have claims against the investment manager of a Ponzi scheme directly, although

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those claims may not be worth much at all, particularly since the investment manager is likely out of business and facing regulatory and/or criminal charges," Paccione said. "You perhaps could have claims against secondary actors, the alleged aiders and abettors of the Ponzi scheme – typically these can be bankers or accountants or advisers."

The types of claims asserted against secondary actors tend to include negligence and allege in substance that the third party aided and abetted the fraud or perhaps aided and abetted the investment manager's breach of fiduciary duty. "Of course, the defenses available to secondary actors in these scenarios are very substantial," Paccione said. "You have to prove, especially on the aiding and abetting side, actual knowledge of the wrongdoing."

Indirect Investors

In the case of indirect investors caught up in a Ponzi scheme, claims can also be filed against feeder funds or fund of funds managers, and would likely include breach of fiduciary duty or misrepresentation based on failure to perform the level of pre-investment due diligence and ongoing investment monitoring promised in marketing materials.

"Indirect investors have a litigation advantage in that they have the ability to assert claims not just against the Ponzi scheme or its investment manager but, assuming you made your investment through a feeder fund, you now have a different class of potential defendants from which you may seek recovery in litigation," Paccione stated. "In other words you could sue the feeder fund and, more appropriately, its investment manager."

The feeder fund, the investment manager and its advisers, as well as the same group of secondary actors targeted in claims filed by direct investors, are also subject to claims by indirect investors. The types of claims seen in these cases generally include securities and common law fraud claims, claims of misrepresentation of material facts, breach of fiduciary duty claims, negligence and gross negligence claims.

Indemnification and Exculpation Clauses

However, in filing claims against feeder funds, investors would likely have to overcome the exculpation clauses in offering documents of the feeder funds. Hedge fund documents typically provide that the general partner or investment manager will be indemnified and exculpated by the fund to the extent permissible under applicable law, provided that their actions do not constitute gross negligence, willful malfeasance or misconduct, fraud, bad faith or dishonesty.

Clawbacks

In general, clawbacks are actions by the trustee to recover profits paid out to (and in some cases principal invested by) investors within a certain period prior to the filing of the SIPA or bankruptcy proceeding, for distribution to other investors.

There are two types of clawback claims: preference claims and fraudulent conveyance claims.

Preference claims seek to avoid payments made by the bankrupt entity within the 90 days prior to its bankruptcy filing. Investors involved in a preference claim have limited defenses, such as the "ordinary course" defense – which, under Section 547(c)(2) of the Bankruptcy Code provides a creditor (or investor) with a defense to a preference complaint if the creditor (or investor) could prove that the payment was (a)

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for a debt incurred in the ordinary course of business between the debtor and the creditor; (b) made in the ordinary course of business between the debtor and the creditor; and (c) made according to ordinary business terms in the relevant industry. There is also a defense provided under Section 546(e) of the Bankruptcy Code that says that money received in connection with a settlement of a trade is generally excepted from a preference clawback claim.

Fraudulent conveyance claims concern the illegal transfer of property with the intent to commit fraud. Investors have been subject to such claims in connection with other Ponzi schemes, such as the scheme involving Bayou Group LLC. In December 2008, the federal bankruptcy court overseeing the Bayou case ruled that investors who had redeemed their investments from Bayou, sometimes years before Bayou's fraud was detected, had to give back profits, and even some of their initial investments, to help offset losses by other investors ensnared in the scheme. "The fraudulent conveyance aspect of these clawback claims is something that I think is interesting," Paccione said. "You need to understand two things about fraudulent conveyance: first, in order to be deemed an intentional fraudulent conveyance, you would have to receive a transfer that was made with an actual intent to defraud creditors. If you received profit from your investment in a Ponzi scheme when you received your withdrawal, that is automatically deemed to be an intentional fraudulent conveyance. The second issue is whether or not your principal was taken out 'not in good faith.' What that means is that you took it out with notice of wrongdoing of the underlying Ponzi scheme."

For more on potential clawback claims as they relate to Madoff investors, see "Certain Madoff Investors May Find Themselves in an Unusual Dual Role – As Potential Lawsuit Plaintiffs or SIPA Claimants, but also as Potential Clawback Defendants," The Hedge Fund Law Report, Vol. 2, No. 9 (Mar. 4, 2009). For more on the Bayou case, see "Bayou Creditors Sue Goldman Prime Brokerage Unit to Avoid Allegedly Fraudulent Transfers," The Hedge Fund Law Report, Vol. 1, No. 13 (May 30, 2008).

Insider Trading Risks, Remedies and Rights

Investors in hedge funds whose managers are embroiled in insider trading allegations are concerned about whether money withdrawn from the funds may be subject to fraudulent conveyance or preference claims of the sort generally brought in the wake of a Ponzi scheme.

Katten Partner Scott Resnik stated, "If you find yourself in a fund where the manager is charged with insider trading, my first piece of advice is to get your money out. From a legal standpoint, there is a danger to your money if it's invested with someone who is indicted, under investigation or charged with insider trading. The government can move to seize accounts. However, from a practical standpoint, if you look at recent insider trading cases, the government has demonstrated generally a low to de minimis interest in chasing the funds of innocent investors who invested in the infected hedge fund. For example, we saw in the Galleon case that while many investors pulled money from the fund after the indictments were announced, the government did not move to freeze or seize innocent investor funds."

Resnik noted that in insider trading cases, the investor does not stand nearly as great a risk of loss of invested capital (versus investors in Ponzi schemes). "In insider trading cases, the innocent investor doesn't stand nearly as great a risk

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in losing its money as the investor would if it found itself invested in a Ponzi scheme. The primary reason for this is that insider trading and Ponzi schemes are fundamentally different types of crimes. In a Ponzi scheme, the investor is the victim and the government must act quickly to freeze whatever existing assets there are in place if there is any hope of restituting the investor-victims. In insider trading, the victim is more abstract. The victim is the market or potentially all of the shareholders in a given corporation. The crime of insider trading does not function by design, as a Ponzi scheme does, to put innocent investor money in danger. The government's main interest in insider trading cases is to pursue the actual wrongdoer and extract the moneys that are due back to the market or the government from the actual wrongdoers themselves."

Increased Volume of SEC Investigations

In light of the financial meltdown and the embarrassment of failing to catch the long-running Madoff Ponzi scheme, the current SEC administration is trying to rejuvenate itself and reclaim its role as an effective watchdog of securities markets. The SEC has undertaken several initiatives recently to become more effective, responsive and relevant.

One such initiative announced by the SEC's Enforcement Division, led by Director Robert Khuzami, was the introduction of new investigative units designed to enhance and revamp its investigation efforts, as well as to encourage witness cooperation in investigations. See "SEC Names New Co-Chiefs of Enforcement Division Asset Management Unit and Other Specialized Unit Chiefs," The Hedge Fund Law Report, Vol. 3, No. 3 (Jan. 20, 2010).

Aside from restructuring its Enforcement Division, the SEC also recently announced plans to encourage individuals to cooperate with the agency's investigations and enforcement actions through cooperation agreements and deferred and non-prosecution pacts.

Resnik said that the steps taken by the SEC to foster cooperation among potential defendants to help pursue SEC cases is an incredibly significant move. It demonstrates, according to Resnik, a recognition on the part of the SEC that one reason the Department of Justice has been so effective over the years in investigating and prosecuting white collar crime is that they have in place a system to recruit and reward cooperators.

However, in implementing its new cooperative regime, the SEC will have some hurdles to overcome. According to Resnik, "One of the obstacles that the SEC will face in trying to implement a cooperation regime is that the Enforcement Division will have a limited ability to protect cooperating defendants from collateral consequences of their admissions to the SEC, namely from the DOJ or from third party civil lawsuits. Also, there is a large tension between the SEC's proposed cooperation regime and its preference to resolve cases where parties neither admit nor deny allegations. In addition, the SEC has to overcome the historic lack of transparency in SEC settlements. If you want people to cooperate with you, they have to see that there is a real, tangible benefit of that cooperation."

Resnik also highlighted the SEC's recent increase in its enforcement activity. In Fiscal Year 2009, the SEC opened 944 investigations, a six percent increase over the 890 investigation opened in Fiscal Year 2008. On the flip side, in Fiscal Year 2008, the SEC closed 1,355 investigations while

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closing only 716 in Fiscal Year 2009 – a 47 percent decrease. Indeed, the SEC has announced several high profile investigations in recent months. Perhaps most notable was the October 2009 filing of criminal charges against several people involved with the Galleon Group family of hedge funds and New Castle Funds, LLC, for allegedly engaging in a massive insider trading scheme. Specifically, the government accused Raj Rajaratnam, founder and manager of Galleon, Mark Kurland, a top executive at New Castle, and Danielle Chiesi, a New Castle employee, of contacting a network of close business associates, including Rajiv Goel, a managing director at Intel Capital, Anil Kumar, a director at McKinsey & Company, Robert Moffat, an IBM senior executive, and one another, to obtain confidential information about corporate earnings and takeover activity at several public companies. See "Billionaire Founder of Hedge Fund Manager Galleon Group, Raj Rajaratnam, Charged in Alleged Insider Trading Conspiracy," The Hedge Fund Law Report, Vol. 2, No. 42 (Oct. 21, 2009).

Also, in November 2009, the SEC and the U.S. Attorney's Office for the Southern District of New York announced the indictment of Joseph Contorinis, a former Jefferies Group, Inc. hedge fund portfolio manager, on charges of conspiracy and securities fraud relating to his alleged participation in an insider trading conspiracy ring. See, "Another Hedge Fund Manager, Former Jefferies Group Manager Joseph Contorinis, Indicted for Insider Trading," The Hedge Fund Law Report, Vol. 2, No. 46 (Nov. 19, 2009).

SEC Examinations Post-Madoff

With its new cooperation initiatives and enforcement units, the SEC is expected to shift its investigative focus to more "reality-based examinations," noted Meryl Wiener, Partner and Member of Katten's Financial Services Practice. Internal examinations will also help a fund prepare for an SEC exam. For more on internal investigations in the hedge fund context, see "For Hedge Fund Managers in a Heightened Enforcement Environment, Internal Investigations Can Help Prevent or Mitigate Criminal and Civil Charges," The Hedge Fund Law Report, Vol. 2, No. 47 (Nov. 25, 2009).

"When conducting an internal examination, you need to verify the assets actually exist and are where they are supposed to be, that trades reported were actually made, and that account returns are as reported. If there are inconsistencies, heightened scrutiny is required. Don't brush it aside. You need to dig deep," Wiener said.

The SEC will be looking at funds' policies and procedures during investigations to ensure they match up with what is actually being practiced, Wiener noted. The SEC will place greater scrutiny on inconsistencies and other suspicious irregularities, she added.

Wiener also emphasized that verification of assets, returns and trade executions will be critical during examinations. "It is no longer enough to 'trust but verify' when it comes to assets. The philosophy is now simply: 'verify.'"

Other steps to be undertaken in an examination include: verification of a firm's auditors and audits; verification of the reputation of the auditor; and obtaining custodian statements, comparing them with advisory records and trying to reconcile any discrepancies. The SEC has also be reaching out to counterparties, custodians and clients to ensure information given to the regulator is in line with what is given to service providers and investors. The overarching goal is to ensure that investor assets are intact and actually held by the

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custodian, as reported to investors.

For more on preparing for an SEC audit, see "Key Lessons from the Second Annual Hedge Fund Tax, Accounting & Administration Master Class: IFRS, Fair Value and SEC Examinations," The Hedge Fund Law Report, Vol. 2, No. 21 (May 27, 2009).

Prophylactic Measures

According to the Katten partners, hedge fund managers can take several preventative measures to help reduce their chances of becoming ensnared in insider trading or Ponzi scheme allegations.

Create a Culture of Compliance

First and foremost, fund managers should create a culture of compliance within their firm. According to Paccione, steps to create a culture of compliance start with the "tone at the top." Senior management needs to establish and maintain an effective and robust culture of compliance throughout the firm.

"Firms need to establish a culture of compliance," Wiener emphasized. "SEC-registered advisers must (and non-registered advisers should) have a compliance program with written policies and procedures and a chief compliance officer to oversee the compliance practices."

But having written policies and procedures in place is not enough, Wiener added. "Great policies are irrelevant if they don't work. You need to regularly test the effectiveness of your policies and procedures. You need to update these policies and procedures as your firm and business expands and changes."

Avoid Regulatory Exposure

Paccione noted that investment managers should make sure their firms' policies, procedures and codes of conduct are in accordance with current regulations. Hedge fund managers also need to ensure that employees are properly trained and supervised with respect to the firm's compliance policies and procedures, in order to avoid some of the hot-button regulatory issues.

Communicate

Fund managers that become embroiled in a particular issue will find it is extremely important to communicate with investors carefully. If there is a regulatory inquiry or other issue, it is important to be as truthful and forthcoming about the issue as possible. Cover-ups and misleading disclosures to investors about problems can lead to litigation down the road. The key is to be "upfront, upright and contrite," Paccione said.

Distinguish Between Market Color and Material, Non-Public Information

To avoid insider trading allegations, it is critical that the portfolio manager, compliance personnel and traders be able to distinguish between market color and material, non-public information.

Generally, hedge fund managers may not trade securities based on material, non-public information, particularly where such information is obtained from someone with a fiduciary duty to the issuer of those securities. At the other end of the spectrum is public information, such as that gleaned from publicly filed annual or quarterly reports. Between these poles is so-called "market color," which generally refers to information that is more specific to a company, industry or market than public information, but that does not rise to the level of material, non-public information.

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With the SEC stepping up its investigations of insider trading violations, hedge fund managers and management company personnel must be cognizant of the subtle distinctions between market color and inside information. In the course of researching possible investments, hedge fund managers collect, analyze and act on a significant amount of complex information. In the course of this data collection, they often speak with corporate insiders and, during the course of these discussions, hedge fund managers may legally obtain facts and opinions that, when combined with other immaterial, non-public or material public information constitutes a "mosaic." The mosaic theory, in broad terms, permits trading based on a combination of information that incorporates material, public information; immaterial, non-public information; and the thoughts, impressions and judgments of the trader (to the extent such thoughts, impressions and judgments are not themselves the product of material, non-public information). See "How Can Hedge Fund Managers Distinguish Between Market Color and Inside Information?," The Hedge Fund Law Report, Vol. 2, No. 46 (Nov. 19, 2009); "How Can Hedge Fund Managers Talk to Corporate Insiders Without Violating Applicable Insider Trader Laws?," The Hedge Fund Law Report, Vol. 2, No. 43 (Oct. 29, 2009).

Look Out for the "Toxic Tile"

With insider trading cases, Resnik noted, "folks tend to look at the mosaic theory as being a bullet-proof vest against insider trading and it's really not always that simple. You have to watch out for the 'toxic tile' in your mosaic. If your mosaic gets infected by material, non-public information, you can find yourself in a lot of trouble."

Resnik added, "Everyone in this industry is in the information business, you have to collect and sift through a lot of information before making trading decisions. At one end of the spectrum you have material, non-public information, which everyone knows is verboten. At the other end of the spectrum you have public filings. The information that lies between those two poles is what is commonly referred to as market color. It generally refers to information that is more specific to a company, industry or market than public information but does not rise to the level of material, non-public information. The line between market color and inside information is really the million dollar question, and it's far easier to calculate in hindsight – but even then it can still be a very blurry and contentious decision."

For a comprehensive discussion of practice points that can help hedge fund managers avoid insider trading allegations, including links to relevant articles from The Hedge Fund Law Report, see "Regulatory Compliance Association Hosts Program on Increased Risk for Hedge Fund Directors and Officers in the New Era of Heightened Regulation and Enforcement," The Hedge Fund Law Report, Vol. 2, No. 50 (Dec. 17, 2009).

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