This article first appeared in a slightly different form in *Hedge Funds Review*, 19 February 2010

INSIDER TRADING CASE HAS IMPLICATIONS FOR HEDGE FUNDS INDUSTRY

By Angela Hayes

The course of the largest hedge fund insider trading case in history, with the Galleon hedge funds at the centre, will continue to attract close attention over the coming months. There are over 20 accused. Some months after formal charges were lodged, a federal grand jury has returned indictments against the central defendants Raj Rajaratnam, the founder of Galleon, and Danielle Chiesi, a Bear Stearns employee. Six defendants, including a New York lawyer, are said to have pleaded guilty to criminal charges.

The profile and seniority of the various defendants and the FBI's investigation tactics, with wire taps and an unnamed whistleblower, make for a heady combination. Galleon's aggressive style in pushing its bankers for market colour has been widely reported. This has overshadowed the facts alleged in the prosecution documents and has led to concerns about the boundary between legitimate investment research and market intelligence as against illegitimate tipping of confidential inside information.

The dismissal of the US insider trading case against Mark Cuban in 2009 also led to questions about the precise boundary of insider dealing restrictions and whether there may be significant differences between the US and UK law.

There is nothing new in the Galleon case in terms of the type of behaviour being complained about or the way the US prosecutors are seeking to apply the law. For those who aim to comply with the law there is nothing materially different in the practical application of UK and US laws on insider dealing.

What is new about Galleon is the evidence gathering methods used for the first time in an insider dealing case, although these have been commonly used by the FBI and US prosecutors in other types of fraud.

The information alleged to have been used by the core Galleon defendants was ultimately obtained from company insiders, whether executives of the companies concerned or professionals who were advising on imminent deals or announcements. The recipients who traded knew or had good reason to know the information they received had been obtained from an insider in and was confidential.

For the most part the information relied on seems to have been reasonably precise, although in some cases delivered in a coded way. So the US prosecutors' central allegations are based on plain vanilla misuse of confidential corporate inside information.

The US Securities and Exchange Commission (SEC) is not seeking to stretch the boundary to prosecute on the basis of mere hints and imprecise information.

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There are differences of detail between the US and UK law. The loopholes exploited by US defendants, notably most recently by Mark Cuban, will be relevant for the Galleon defendants. A defendant breaches the antifraud provisions of the 1934 Securities Exchange Act and rules made under it if he/she misappropriates material non-public information for trading purposes or trades a security while in possession of material non-public information in violation of a duty to withhold the information or refrain from trading.

In July 2009 the District Judge in Dallas threw out the SEC's case against Cuban, the Dallas Mavericks owner, holding that in addition to agreeing to keep the information confidential the recipient would also need to have agreed not to trade.

The SEC considers the judge got the law wrong and that trading in circumstances where you know that the information you have received is confidential is sufficient to trigger the offence. Only the foolhardy would set out to trade intending to rely on distinctions like that drawn by the judge in the Urban case. the legal costs of defending a case and the reputational damage plus the risk of imprisonment and high fines are not worth it.

Under the counterpart UK criminal law (Section 52 Criminal Justice Act 1993) a person who knows he has information obtained from an inside source and trades in the relevant securities has committed the criminal offence of insider dealing. In contrast to the US legislation, there is no language of "duty" or "misappropriation".

The UK Financial Services Authority (FSA) can also impose civil fines or public censure for market abuse even where the defendant did not believe the information he/she received was inside information and so did not intentionally break the law.

In 2009 the FSA censured two individuals for trading ahead of a new bond issue even though the FSA accepted expert evidence that bond market participants did not view the information concerned as price sensitive or the trading as improper.

The SEC can also impose civil sanctions for insider dealing. In the US the civil case is based on the same offence as that used in criminal prosecutions and will not catch a broader range of behaviour.

In the UK there are also both criminal and civil sanctions for improperly disclosing inside information to others. It has been best practice before any potential legitimate disclosure of inside information to warn the recipient first that the information is confidential inside information, to obtain their specific agreement to receive the information on that basis with the effect that the recipient will be restricted from dealing.

In the US, particularly following the Urban case, that should also be best practice.

It is true to some extent that the US insider dealing prosecutors have more intrusive powers available to them than the FSA. One example of this is to intercept telephone calls.

However, Galleon is the first case where telephone interception has been successfully used in an insider dealing case. This was possible because investigators were able to find a co-operating witness early on in the investigation. This enabled the investigators to overcome legal hurdles of proving there was a serious case to answer in order to obtain the court's permission to use the phone tap.

In the UK the power to intercept telephone calls is not available to the FSA. It is only used by authorities such as the police and intelligence services. So the FSA is limited to reviewing calls that have been recorded by regulated companies under FSA requirements.

However, the FSA is able to use more limited powers to obtain details of a subscriber behind a telephone number or when and to whom calls or emails were sent by particular subscribers.

Because of the Galleon case, US prosecutors are more likely to use these evidence gathering tactics more often in insider dealing cases.

For the FSA its concerns with maintaining market integrity make it unlikely the FSA would stake out wrongdoers over an extended period like in the Galleon case.

The need for due care in receiving and dealing with inside information remains the same. In the UK the FSA's heightened appetite for pursuing civil sanctions, even in cases where there was no intentional wrongdoing, makes identifying inside information an increasing minefield for managers and traders, particularly outside the mainstream equity markets where there is much less regulatory guidance available.