A number of recommended changes to insider trading investigations could help the Securities and Exchange Commission come to grips with the temptations that have accompanied the rise of activist investors, Wall Street experts say.

A congressional report two key lawmakers issued calls on the SEC to make a plethora of changes, such as allocating more resources to track insider trading. A case involving a large hedge fund and a prominent investment banking executive instigated the report.

Sens. Charles Grassley, R-Iowa, and Arlen Specter, R-Pa., released an interim report Friday, Aug. 3, raising questions about whether the SEC gave Morgan Stanley chief executive John Mack special treatment during a probe of insider trading at Westport, Conn.-based Pequot Capital Management Inc., which runs $7 billion in hedge funds. Their examination of the matter began before Congress changed hands following the 2006 elections and they were still chairmen, respectively, of the Senate Finance and Judiciary committees.

The report recommends that the agency create a standardized employee evaluation procedure, draft a manual of procedures for conducting enforcement investigations and allocate additional resources to its enforcement division. The redeployment of resources would take place after commission officials identify how many staff-members it needs to do a better job of identifying hedge fund related insider trading.

Vikas Agarwal, assistant professor of finance at Georgia State University's J. Mack Robinson College of Business, said he believed implementing these recommendations could improve the agency's enforcement of insider trading by hedge fund managers.

Agarwal said he believes the greater number of hedge fund insider trading cases is connected to the growth of merger arbitrageurs and activist investors that buy large minority stakes at companies and agitate for changes to improve the share value of target corporations. "As hedge funds start playing a more active role in the management of companies, they are accumulating a great deal of information that their hedge fund predecessors may not have had access to," Agarwal said. "While pressing for a sale, they may gain nonpublic information about a prospective sale."
Another recent phenomenon, hedge funds lending capital to corporations, may also be a factor. When hedge funds lend capital to companies, they often have access to information, such as a planned merger, that they may want to trade with investment bankers and other hedge funds in exchange for other favors.

The report expressed suspicion over the agency's motivation for terminating attorney Gary Aguirre, who said he was fired in September 2005 after he pressed for a further investigation into a possible insider trading relationship between Pequot and Mack. It also expressed outrage over SEC Inspector General Walter Stachnik's examination of the matter.

Even though congressional staffers reviewed more than 10,000 pages of documents related to the Aguirre firing, drafters of the report expressed concern that there was not enough documentation of communications between key SEC supervisors, agency staff and outside individuals under investigation. It suggested that the agency improve its documentation efforts and discourage supervisors from engaging in communications with subjects of inquiry without the knowledge of the lead SEC staff attorney assigned to the matter.

The SEC had been investigating whether Pequot relied on insider information to buy the stock of Heller Financial Inc. before its 2001 takeover by General Electric Co. Aguirre told lawmakers on Capitol Hill that he was fired after senior SEC officials purportedly rebuffed him in his efforts to question Mack.

SEC Chairman Christopher Cox said in a statement that he met with the two lawmakers recently. Cox added that he will follow up on the recommendations. Some are already being implemented.

Cox said July 31 a special hedge fund insider training task force will operate within the division of enforcement and coordinate efforts with other federal law enforcement agencies and stock exchanges.