At our trading desks, every hedge fund would call to buy the same popular security. We would laugh, and say: “We just got off the hedge fund conference call.”

Federal authorities scupper Galleon Group, a multi-billion dollar hedge fund. Vanessa Drucker reports from New York on the scandal that rocked Wall Street and examines the extent of insider trading – and the difficulties of proving and winning a case.

As October 16 dawned, agents from the Federal Bureau of Investigation (FBI) handcuffed Raj Rajaratnam, a billionaire, at his Manhattan apartment, launching the largest insider trading case in a generation. The 52-year-old Sri Lankan immigrant had been running Galleon Group since 1997, a hedge fund that oversaw $7 billion (£4.2 billion) in assets at its peak.

Along with Rajaratnam, federal prosecutors and the Securities and Exchange Commission (SEC) charged five other defendants that Friday. A few weeks later, on November 5, prosecutors swooped again, arresting another nine people for criminal conspiracy and illegal trades allegedly executed over three years, resulting in as much as

Shipwrecked
The scandal, which has rocked Wall Street, has far-reaching implications: how widespread is insider trading, among the hedge fund community, other financial institutions, and even deep in corporate America? Are the Galleon cast of characters a barrel of exceptionally bad apples? Or did authorities choose it for an example, picked as a warning at large?

Information is constantly exchanged in the incestuous hedge fund community, as those engaged in so-called fast money discuss their activities. These conversations may consist of gossip or “intentions”, such as: “You should consider this or that stock” or “Let’s both buy it.”

The line between illegal and unethical can be thin. “Most sell-side people inside the investment community firmly believe that a significant percentage of hedge fund activity is questionable,” says Stanley Fortgang of LECG, who traded fixed income at Goldman Sachs from 1990 to 2000, and at Morgan Stanley from 2001 to 2008. He adds: “Another significant portion would argue many hedge funds are completely corrupt. They see the Galleon case and they snicker.”

None less than Robert Khuzami, the SEC’s enforcement director, labelled hedge funds’ aggressive information gathering as “systemic”. At the Bloomberg Washington Summit on November 13, Khuzami characterised that behaviour as “potentially more dangerous” than opportunistic trading.

“If you put a lot of sugar in one place you get ants,” comments Vikas Agarwal, a finance professor at Georgia State University. He refers to the proliferation of bad, mediocre managers who have flooded the hedge fund industry, many migrating from the mutual fund space. Whereas earlier generations of hedge fund managers often represented the most talented and hard-working people, the phenomenal returns of that era drew in a new crowd of less stellar professionals. While these might not act in strict collusion, they behaved like a herd of sheep, Fortgang recalls: “At our trading desks, every hedge fund would call to buy the same popular security. We would laugh, and say: ‘We just got off the hedge fund conference call.’”

A core question is whether hedge funds have achieved better returns, or alpha, because they are more skillful, or because they are less regulated and operate on the cusp of questionable activity. Agarwal estimates that about 4,300 hedge funds were operating in 2001, growing to 7,100 by 2005, and probably numbering close to 10,000 today. With so many players, there is pressure and temptation to seek even the smallest edge.

Agarwal reports that he has collected and analysed data on hedge fund fraud, discovering only about 100 cases over a 10-year period to the end of 2007. While it somewhat surprised him to find a relatively modest number, compared with corporate instances, he considers the possibility that some hedge fund fraud is under-reported to the SEC by those investors who lose money.

Or perhaps insider trading activities extend beyond the hedge fund universe, deep into the corporate world. The Galleon case in itself reveals a wide network of well-placed individuals in high-level corporate positions in publicly-traded companies. The group of those charged included executives from Intel, McKinsey, Moody’s, a former Bear Stearns fund and others. One Galleon employee, Zvi Goffer, had penetrated so many circles that fellow scammer nicknamed him “The Octopus”.

John Hueston, an attorney at Irell &
Manella, cross-examined Kenneth Lay in the Enron case in 2002 as co-lead prosecutor. He notes that the Galleon interconnections “show a network of alleged greed through layers of corporate America, highlighting the dangers of comprehensive trading of information.”

Hueston argues that insider prosecutions serve at best as deterrents. “When corporate America relies on a criminal process to remedy the system, the system is already broken. Resources deployed almost always exceed monies recovered,” he says.

Consider how some motorists exceed the speed limit, sometimes zooming over 90mph. There are never enough police to guard every corner. Police may leave a decoy, a patrol car with blinkers and a mannequin inside, to send speed demons a message. If the point of insider trading enforcement is to deter conduct, then catching smaller cases may even be more effective, as a warning that small-fry cannot count on escaping attention.

With their limited resources, government authorities face two sets of challenges. It is difficult enough to identify sufficiently suspicious insider trading patterns; then comes the daunting task of prosecution. “Until five years ago, the government spent more on Marine Corps marching bands than on the whole SEC budget,” notes Jim Heinzman, managing director at Actimize, whose software regulators use to monitor trading.

The most straightforward cases develop when an insider comes forward to rat out a scheme. More typically, regulators start by combing their software to pinpoint a spike in trading volume or price of a security, especially surrounding business announcements, like mergers, drug approvals or mineral discoveries. Algorithms calculate price and volume fluctuations over a period, perhaps six months, and how they may deviate from a current price function. A discrepancy of, say, two standard deviations, might signal an anomaly.

Once regulators spot an anomalous deviant, they must establish exactly who traded in front of a news event. “Unlike private firms, the SEC does not have access to customer information data, like names, identity numbers”

**Institutional Perfromer Since Launch**

To show what others buy and buy what others ignore is outside the comfort zone of most investors — but it’s where the true contrarian manager is in his element. In fact, the true contrarian feels uncomfortable when in the majority — believing profit opportunities to be more limited when he’s running with the herd. This independent thinking has made Fidelity Special Values the No. 1 industry performer. Over 23 years, the fund has sought undervalued opportunities among stocks popular opinion shuns. These include under-owned stocks, those with uncorrupted assets or growth potential, and others where corporate activity can unlock value. Of course, the fund also targets recovery situations, but the breadth of objective and contrarian style could deliver clients a fund that performs in many phases of the market cycle. Just look at its record under Sanjeev Shah since January 2006: It has outperformed 94% of peers in varied and challenging markets. And since the start of this year, it’s 9% ahead of the FTSE All Share Index.

The fund seeks out the unpopular and the underown and is attracting a large share of popular assets. Could your clients benefit from a healthy dose of contrarian thinking?

Call or click today.

Hear directly from Sanjeev Shah at The Fidelity Investment Forum

25 - 28 January 2010

Call or click to reserve your place
or historical trading records of customer positions,” Heinzman explains. So the SEC must perform a labour-intensive “Blue Sheet” request, asking the major firms who cleared and settled the suspect trades for information from their own control lists. It takes time for the firms to search many months through a “lookback period”, and respond, possibly to several further rounds of questions. For instance, if someone consistently trades 1,000 shares on the third Tuesday of each month, even a large transaction may not merit further investigation.

The next level involves an analysis of relationships and patterns. “The SEC, which is mostly composed of lawyers and accountants, may lack the street smart-type skill-sets for forensic review,” says Heinzman. Enter professionals, such as Steve Lee, who runs a forensic detective service from Los Angeles. Lee, who has conducted numerous high-profile cases, looks for social networking data, such as old school ties, charitable contributions and connections between firms and individuals. The paper trail may encompass telephone contact records or personal emails unrelated to trading.

“Hedge fund managers are typically younger, less risk averse and less experienced with regulations than other investment institutions,” Lee suggests. “They may be more flat-footed about protections like document retentions.” He points out some of the naivety and “sheer silliness” in the reported Galleon activities, like disposable cell phones – was someone watching too much television? According to security experts, disposable phones, which narcotics traffickers use, tend to attract attention and encourage surveillance. Even secure land lines, with digitally-encrypted voice communications, would be safer. Lee doubts Galleon participants ever consulted their own attorneys, who would have recommended they “convey information face-to-face, or get a runner.”

Having assembled multiple clues, drawn inferences and established plausible connections, authorities typically move in like a special weapons and tactics (Swat) team clearing a building. They pick targets, moving swiftly from one witness to another, trying to induce...
cooperation in return for plea bargains. Proving and winning an insider case now becomes a huge hurdle. The prosecution must be able to show knowledge and intent, the latter always the hardest element. The Galleon case is most notable for its use of wire-taps as an investigative technique, hitherto an unusual ploy outside of organised crime, narcotics distribution or counter terrorism. “It’s time-consuming to apply to a judge for a wire-tap. Then you must commit resources to monitoring and interpreting it,” says Andrew Hruska, an attorney with King & Spalding, who previously obtained and supervised wire-taps during his eight years in the state and federal justice systems. “But they are very effective, even more than written correspondence or emails, to show a jury what defendants were saying or thinking in unguarded moments.”

More crimes are committed than prosecuted, so authorities must choose their battles carefully, and win them. Losing is a big black eye, like the recent acquittals of Ralph Cioffi and Matthew Tannin, former Bear Stearns hedge fund managers who were accused of misleading investors. “It’s a momentum game,” says Hueston. “If they succeed, that inspires more cases, but if not, it will be seen as a waste of resources.” Besides, there is value in law enforcement to getting recognition. Regulators can hire better candidates when they are perceived as being effective.

If nothing succeeds like success, did authorities initially decide to focus on Rajaratnam because his case seemed winnable? Hueston guesses that the FBI had “developed a terrific cooperating witness, which is how big cases inevitably start.” Craig Lilly, an attorney with Squire, Sanders & Dempsey, agrees that a key to convictions is often a cooperating witness – an element missing from the Bear Stearns case, which depended only on email exchanges. He says the Galleon matter appears egregious, “because of the quantity of trades, number of corroborating witnesses, and pattern of a long-term course of conduct, rather than an isolated incident.”

Some observers have suggested that Rajaratnam could serve as a whipping boy, or at least as a defendant less sympathetic to a jury. Was the heavy-set Sri Lankan billionaire, with his network of mostly Asian alleged co-conspirators, picked in part for its image as a group of outsiders?

Yet the complexity of the web, and the scope and scale of activity would indicate that was not a primary reason. Perhaps, though, “Connecticut Yankees” differ from the Galleon protagonists in style, Lee suggests. Lilly, who does not regard Rajaratnam as a scapegoat, nonetheless considers that “gambling can be more pervasive and acceptable in eastern cultures, where stock trading is also perceived that way. It might even lead to some cultural disregard for western rules.”

It is one matter to take investment risks, but what would motivate anybody, from any culture, to jeopardise an entire livelihood, and even their freedom, for such comparatively meagre sums? Recall that the charges involve profits of about $53m, a kind of hedge fund shoplifting in the context of a $7 billion empire.

On one hand, the pressure to perform in the hedge fund industry is immense, with status built around an ability to beat the market. So every dollar counts. “Money becomes more than money, but a means of keeping score against competitors,” says Hruska. Besides, insider traders rarely get caught immediately. Like a child who is not punished right away, it may seem tempting to keep pushing their luck. Alternatively, that $53m could be the tip of an iceberg. “For all we
The case for no case

A minority of academics and legal experts contend that insider trading is a victimless crime and should be legalised, generally citing a cost benefit argument. “They maintain that if you have to spend more resources on catching the criminals than the benefits you gain, it’s probably not worth it,” Vikas Agarwal, a finance professor at Georgia State University, explains.

First, it is impossible to police or enforce the law on a widespread scale, since most instances are undetectable. A few publicised cases must serve as deterrents.

A more subtle thesis centres on market efficiency. Some facts usually seem from insiders to become incorporated into prices, moving them to correct levels – or at least economic realities. In theory, insiders should even be trading and arbitraging among themselves, acting as their own whistleblowers.

Any given piece of data can constitute a chunk of a final mosaic that renders the whole jigsaw puzzle understandable. “If courts were to treat the final jigsaw pieces as material, that would reduce the speed with which information is impounded and discounted into asset prices. Any chilling effect on impounding would interfere with a fundamental tenet of how securities markets operate,” says Steve Lee, who runs a forensic detective service from Los Angeles. “We rely on outsiders’ pursuit of self-interest and extremely rapid price changes to produce efficiency.”

A much more dubious proposition states that insider trading works as an incentive, an adjacent “way to compensate insiders,” says Agarwal. During the internet boom in particular, advantageous information often enabled firms to attract talented employees less expensively.

Defenders of the status quo respond vigorously, that insider laws protect overall confidence. The Securities and Exchange Commission (SEC) announces on its website that it enforces violations as a priority, because “insider trading undermines investor confidences in the fairness and integrity of securities markets.”

“We rely on outsiders’ pursuit of self-interest and extremely rapid price changes to produce efficiency”