

## Alert

### New Regulatory Scrutiny of Communications Among Hedge Fund Managers

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Recent news reports indicate that a number of different regulators are investigating communications among hedge fund managers. There are no general prohibitions on fund managers discussing investment ideas with each other. Managers should, of course, be mindful of the rules against market manipulation and insider trading as well as the rules regarding agreements among competitors that could present antitrust and securities law concerns.

Regulatory scrutiny of financial firms has been ratcheted up yet again with news in *The Wall Street Journal* of an investigation launched by the U.S. Department of Justice into whether hedge funds might have “banded together to drive down the value of the euro.”<sup>1</sup> Although the DOJ’s Antitrust Division commenced the investigation, the Securities and Exchange Commission and Federal Reserve also are exploring the matter, according to the article, and Congress has planned hearings in the coming weeks to investigate whether U.S. financial firms may have played a role in the euro’s decline. In the midst of Greece’s debt crisis relating to Europe’s largest budget shortfall, and amid concerns that the crisis may quickly spread to other countries, the euro has come under intense selling pressure, losing over ten percent since November.<sup>2</sup>

According to *The Wall Street Journal*, the Justice Department’s Antitrust Division has sent letters to certain hedge funds that attended a Feb. 8, 2010, “ideas dinner,” hosted by a boutique brokerage firm at which a representative of one fund is described in the article as disclosing that funds managed by his firm were shorting the euro and urging other fund managers to short the euro. The letters request that the hedge funds preserve documentation relating to the dinner. The DOJ letters apparently were sent later in the same day that *The Wall Street Journal* first reported on the ideas dinner.

In light of the government’s focus on these issues, it is important to bear in mind the prohibitions regarding improper collusion among market participants as well as applicable securities laws.

#### Antitrust

Any evidence gathered by the Antitrust Division may be used to determine whether there was an agreement to collude relating to positions taken against the euro in violation of Section 1 of the Sherman Act.

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<sup>1</sup> See Susan Pulliam & Kate Kelly, “U.S. Probes Bearish Euro Bets – SAC, Greenlight, Soros, Paulson Told to Retain Records; a Collusion Question,” *Wall St. J.*, March 3, 2010, at C1 [hereinafter “U.S. Probes Bearish Bets”]

<sup>2</sup> See *id.*; Katherine Burton & David Scheer, “U.S. Said to Tell Hedge Funds to Save Euro Records” (*Update 3*), *Bloomberg*, March 3, 2010, 3:52 a.m. EST.

**Agreements in Restraint of Trade.** Section 1 of the Sherman Act prohibits agreements or understandings that restrain competition.<sup>3</sup> Given the pernicious impact on free trade that results from certain types of agreements, such as price fixing, bid rigging and market allocation, such agreements are deemed to be per se illegal, and liability attaches to them, if proven, without regard to whether the agreement had any impact on price, the market or any other aspect of competition.<sup>4</sup> That being said, independent parallel conduct of entities—acting in similar fashion without any agreement to do so—is not illegal.<sup>5</sup>

To violate Section 1, an illegal understanding or agreement need not be express or even written.<sup>6</sup> Indeed, a tacit understanding, proven from circumstantial evidence, can suffice.<sup>7</sup> Courts have thus found that “unwritten” or “gentlemen’s” agreements,<sup>8</sup> on price or other competitive terms, may support a Section 1 claim.<sup>9</sup> Moreover, courts have found that efforts to communicate or reach an understanding between and among market participants through public behavior, *i.e.*, communicating agreements or understanding through public pronouncements, may violate the Sherman Act.<sup>10</sup>

## Securities Laws

The allegations raised by the investigation also serve as a reminder to fund managers that, while there is no prohibition on their discussing investment ideas, they must be sensitive to any number of potential pitfalls under the securities laws, for example:

**Market Manipulation.** Artificially affecting the price of securities may violate the prohibitions on market manipulation found in Sections 9 and 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (“Exchange Act”)<sup>11</sup> and Section 17(a) of the Securities Act of 1933.<sup>12</sup> The SEC and other regulators in recent months have stepped up their investigations into market manipulation, including into whether investment advisers used rumors, short-selling or other tactics to manipulate the securities of financial companies in the lead-up to difficulties in the financial services industry in 2008.

**Breach of Obligations to Clients.** Fund managers must act for the benefit of investors. Information or ideas about client investments must be monitored and only shared with others outside the firm when doing so would be in the investors’ interests. Managers should have policies and procedures that effectively communicate to employees the types of information that may be shared with others outside the firm and the circumstances in which such information may be shared. Employee training should be used to reinforce these policies and testing should be used to monitor compliance with these policies.

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<sup>3</sup> See 15 U.S.C. § 1 (2006)

<sup>4</sup> Alleged Section 1 violations that fall outside the defined categories of per se illegality are examined under the “rule of reason.” Under a “rule of reason” analysis, “courts must decide whether the questioned practice imposes an unreasonable restraint on competition, taking into account a variety of factors including specific information about the relevant business, its condition before and after the restraint was imposed, and the restraint’s history, nature, and effect.” See *State Oil Co. v. Khan*, 522 U.S. 3, 10 (1997). The ultimate inquiry under the rule is whether the restraint’s anticompetitive effect substantially outweighs the procompetitive effect for which the restraint is reasonably necessary.

<sup>5</sup> See, e.g., *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986) (noting that “if [the defendants] had no rational motive to conspire, and if their conduct is consistent with other, equally plausible explanations, the conduct does not give rise to an inference of conspiracy”).

<sup>6</sup> *United States v. General Motors Corp.*, 384 U.S. 127, 142-43 (1966) (noting that “it has long been settled that explicit agreement is not a necessary part of a Sherman Act conspiracy”).

<sup>7</sup> *Apex Oil Co. v. DiMauro*, 822 F.2d 246, 253 (2d Cir. 1987) (noting that “where the alleged scheme is short-term and relatively simple in operation . . . the best proof available most often will only tend to show the existence of an informal, perhaps, even tacit, rather than explicit, agreement”).

<sup>8</sup> See *Toledo v. Mack*, 530 F.3d 204, 218-20 (3d Cir. 2008) (noting that “gentleman’s agreements” can be sufficient evidence to support a jury’s finding of conspiracy).

<sup>9</sup> See *id.*

<sup>10</sup> See *In re High Fructose Corn Syrup Antitrust Litig.*, 295 F.3d 651, 662 (7th Cir. 2002); *American Tobacco Co. v. Liggett & Myers Tobacco Co.*, 328 U.S. 781, 809-10 (1946).

<sup>11</sup> See 15 U.S.C. §§ 78i and 78j(b) (2006).

<sup>12</sup> See *id.* at § 77q.

**Section 13(d) and Section 16 “Group” Issues.** If different managers are investing in the same issuer and discussing that issuer, they may be viewed collectively as a “group” for purposes of making filings under the Section 13(d) (takeover provisions) and/or Section 16 (insider trading provisions) of the Exchange Act. Under Section 13(d), generally, any person who acquires beneficial ownership of more than five percent of a registered class of shares must disclose the acquisition and certain other information required by Schedule 13D within ten calendar days.<sup>13</sup> Section 16 requires disclosure of certain information by any person who beneficially owns more than ten percent of any class of a registered equity security, and requires disgorgement of any profits earned on purchases or sales of the security that occur within six months of each other.<sup>14</sup> Under both provisions, a group may be deemed a “person” where its members have an agreement, arrangement, or understanding, among other things, for these purposes. Fund managers, in their interactions with one another, should be aware that the SEC has a broad view of the types of facts and circumstances that will trigger group disclosure obligations.

**Insider Trading.** Securities regulators remain focused on what they have perceived to be “systemic” insider trading within the hedge fund industry. In communicating with other investment professionals, fund managers must carefully consider whether they are in possession of material nonpublic information with respect to the security such that the communication might subject them to “tipper” or “tippee” liability.

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<sup>13</sup> See *id.* at § 78m(d).

<sup>14</sup> See *id.* at. § 78p.

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