Alert

Government Ratchets Up Investigation Into Insider Trading Involving Expert Networks

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The charges announced by the Department of Justice yesterday against four consultants and an employee of the expert-network firm Primary Global Research reflect yet another component of the government’s stepped-up efforts to uncover illegal insider trading by institutional Wall Street investors. Last month, the government issued broad subpoenas to numerous funds that may have used expert networks in conducting research about potential investments. Where the expanding investigation ends up may test the boundaries between trading on legitimate information-gathering by research analysts, whose job it is to hunt for crucial bits of information, and trading on the basis of material nonpublic information. Firms that use expert networks — and other paid research consultants — should carefully evaluate the use of these services and make sure they have in place the appropriate safeguards to prevent the misuse of material nonpublic information.

So far, the high-profile criminal prosecutions announced over the past 14 months — starting with the charges filed against Galleon Group’s founder Raj Rajaratnam and up through the recent arrest of Don Ching Trang Chu, another employee of Primary Global Research — have involved the alleged communication of information prosecutors and courts have long regarded as actionable.

The charges announced in October 2009 against Rajaratnam, Danielle Chiesi of New Castle Funds LLC and others, for example, involved alleged trading on nonpublic information about upcoming earnings forecasts and business combinations from sources whom the defendants knew — or should have known — were breaching duties of confidentiality in disclosing the information. The criminal complaint against Rajaratnam, for example, alleges that Rajaratnam purchased Polycom Inc. stock based on information originating from a Polycom executive that the company’s revenue numbers for the quarter would “be good.” It also alleges, among other things, that days ahead of the public announcement that Hilton Hotels Corp. would be taken private, Rajaratnam traded on an illegal tip from a Moody’s analyst covering Hilton that the deal was a “sure thing.” Similarly, the criminal complaint against Chiesi includes allegations that Chiesi traded on, and passed along to Rajaratnam, information from an Akamai Inc. executive that the company would lower its earnings guidance on the upcoming quarterly earnings call.

The recent complaint against Chu is similar in the nature of “material” information allegedly communicated but also highlights how the facts of each individual case must be evaluated on their own. Among the government’s allegations is that Chu wrongfully obtained and passed along to Richard Choo-Beng Lee, a hedge fund manager and cooperating witness for the government, quarterly earnings results — including specific revenue and gross margin numbers — for Atheros Communications ahead of the company’s public disclosure of that information. Elsewhere in the complaint, the government alleges that Chu facilitated consultations between insiders during which the insiders provided material nonpublic information to Lee.
Cases brought by the Securities and Exchange Commission in the past year involving hedge funds appear to rely on the same analysis of materiality and its relationship to the source of the nonpublic information. In November 2009, the SEC announced civil insider trading charges against several investors and a registered broker-dealer in connection with alleged trading on the basis of tips about upcoming corporate acquisitions from Arthur Cutillo, an attorney whose firm was handling the deals and, in that capacity, had access to confidential information about them. On Nov. 15, 2010, the SEC added to the list of defendants a hedge fund and one of its former managing directors, alleging that the managing director traded 3Com Corp. securities on behalf of the fund ahead of an upcoming announcement of an acquisition of 3Com based on material nonpublic information about the announcement that originated with Cutillo. In September of this year, another former hedge fund portfolio manager settled charges initially brought by the SEC in February of 2010 based on allegations that he had traded ahead of upcoming UBS analyst recommendations for the fund and for himself based on tips from an executive director in UBS’s equity research department.

With the charges announced today and last month’s round of subpoenas, prosecutors appear to be delving further into the nature and source of information institutional investors gather to make investment decisions. Unlike the cases above, in which there is likely to be little dispute among regulators as to the materiality of the nonpublic information allegedly communicated or that such disclosure was in breach of a duty to maintain its confidentiality, the vast majority of investment analysts, in conducting their research, gather much smaller, less significant pieces of information from any number of sources in order to formulate an investment thesis, or mosaic. How the government views the nature and materiality of the information, taking into account its sources, will no doubt be a determining factor in its decision to bring a case.

The government’s recent activities also suggest that the current investigation appears to be focused on whether expert networks are being used to develop information that fits within the mosaic arrived at through independent research or are delivering material inside information. In addition to today’s charges, the Department of Justice and SEC last month announced parallel actions against a French doctor and expert consultant who, while a member of the steering committee overseeing one of Human Genome Science Inc.’s drug trials, allegedly provided nonpublic negative details about the trial — involving the death of a patient — to a portfolio manager in the U.S., who then traded for his fund ahead of the company’s public announcement of the results. Although trading around clinical drug trials has long been an area of scrutiny for government regulators, the case aligns with the government’s recent focus on expert networks and the nature and source of information they provide investment analysts.

A civil lawsuit recently filed in Florida by the retail department store Big Lots Inc. against Retail Intelligence Group LLC, an “expert” firm that sells research to hedge funds and other investors, highlights the questions being raised about what constitutes confidential proprietary information. Big Lots alleges that, in obtaining from 72 different store managers data about Big Lots that the company deemed confidential and proprietary — including inventory levels, quarterly sales payroll data and store traffic — the research firm wrongfully misappropriated and aided and abetted the store managers’ duties to maintain the confidentiality of that information.

The insider trading issues implicated in these and other cases are highly fact-specific — such as the circumstances under which channel-checking fits the mosaic of independent research versus implicates insider trading rules, and under what circumstances it involves the misappropriation of confidential proprietary data. SRZ attorneys advise clients on how to approach and analyze these issues and how the client’s compliance policies and procedures should address the use of expert networks, as well as train research analysts in areas requiring particular sensitivity. Recent articles relevant to the development of appropriate compliance programs include “Hedge Funds in the Crosshairs: The Law of Insider Trading in an Active Enforcement Environment,” which appeared in the Feb. 17, 2010, issue of The Hedge Fund Law Report, and “SEC Investigations After Dodd-Frank: A Primer for Hedge Fund Managers and Their In-House Counsel” from Sept. 7, 2010, which discusses Dodd-Frank-related issues hedge fund managers may face.

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