The Hedge Fund Law Report
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Volume 4, Number 20 June 17, 2011

Insider Trading

Insider Trading and Debt Securities: Practical Tips for Hedge Funds in Coping with Regulatory Enforcement

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Financial regulators have recently come to understand a fact put most colorfully by a larger-than-life personality in Michael Lewis's *The Big Short:* "The equity world is a ****** zit compared to the bond market."[1]

Recent events brought more regulatory and judicial focus on the world of debt instruments. The stock market crash of the fall of 2008 was largely precipitated by the implosion of debt instruments linked to sub-prime mortgages loans. These market crises put into relief the relative size and power of the bond markets. The equity markets were, at least as of mid-2009, less than half the size of the debt markets, $14 trillion versus $32 trillion in the U.S. and $44 trillion versus $82 trillion globally.[2] Perhaps understanding this, since 2008, the SEC has begun new, unprecedented investigations of insider trading in the realm of debt instruments.

Hedge Funds and the Debt Markets

Recent events have also brought more attention, for better or worse, to hedge funds that have been active in the bond markets. This was perhaps highlighted most spectacularly by John Paulson's successful bet using credit default swaps (CDSs) against the housing markets and subprime bonds, earning him billions. Paulson's fame merely highlights the fact that hedge funds are a dominant force in the bond markets. While managing just $2.0 trillion in total assets (both equities and debt) in 2007, hedge funds accounted that year for more than 30% of bond market trading volume.[3] Hedge funds dominate certain niches more in terms of trading volume – 80% of high yield bond derivatives, and 85% of distressed debt.

Perhaps as a response to this reality, and its growing understanding of the importance of the debt markets, the SEC recently announced its intent to focus on hedge funds, specifically those in violation of insider trading laws.[4] In 2009, the SEC announced the creation of three specialized units relevant to hedge funds: (1) the Asset Management Unit, focusing on hedge funds, amongst others; (2) the Market Abuse Unit, covering large-scale, complex insider trading schemes; and (3) the Structured and New Products Unit, covering the securities – collateralized debt obligations (CDOs), CDSs and other instruments – thought to have caused the 2008 crises.[5] The SEC's Director of Enforcement publicly noted that hedge funds were "of particular concern" and that the SEC was committed to "pulling back the curtain on hedge fund operations."[6]

The SEC and criminal authorities have begun to use more aggressive techniques in their insider trading investigations. Business Week noted that the SEC was taking a "bolder stance" and is now "[a]rmed with informants, wire taps, and intricate software tools."[7] The Galleon investigation – a prominent insider trading case involving $40 million in allegedly illegal trades, 40 people charged, 25 guilty pleas and the conviction of Galleon's founder, Raj Rajaratnam – marked the first time wiretaps were used to investigate insider trading. Since 2008, the number of insider trading investigations by the SEC – involving equities or debt – has increased.

Given these developments, hedge fund professionals must understand rules governing insider trading generally, how they might end up obtaining inside information and what the civil and criminal authorities might act upon, especially in the realm of debt markets. The remainder of this article is divided into four parts. The first part provides an overview of insider trading laws. The second part reviews potential sources of inside information in the area of debt securities. The third part analyzes recent relevant SEC actions focusing on the source of information in alleged insider trading schemes. Finally, the fourth part provides practical tips for hedge fund managers.

Overview: Insider Trading Law

Insider trading is a species of securities fraud under Section 10(b) of the Securities and Exchange Act of 1934 and the SEC's Rule 10b-5. The elements of insider trading are: (1) the trading in securities on the basis of (2) material (3) non-public information (4) in breach of a duty of trust or confidence and (5) with an intent to deceive (or scienter).

In case law, the element of duty of trust or confidence has changed; the nature of the duties applying to market participants has expanded. There are two general theories of duties giving rise to insider trading: the classical theory and the misappropriation theory.

The classical theory targets corporate insiders (largely officers and directors) who trade based upon nonpublic, material information on their own company in violation of their duty to their shareholders.[8] This theory is grounded in basic fiduciary duty law. Over time, the classical theory came to be applied to not just officers and directors, but also "temporary insiders" – attorneys, accountants, consultants and other temporary fiduciaries of the corporation.[9]

The misappropriation theory concerns trading on the basis of nonpublic information by a corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information (often an insider). Often in such cases, the outsider trades on the basis of material, nonpublic information unbeknownst to the insider.

Among other areas, these theories are applied in so-called tipper/tippee cases. In a tipper/tippee case, the government must show that: (1) the tipper possessed material, nonpublic information, (2) the tipper disclosed it to the tippee, (3) the tippee traded in the company's securities while in possession of the insider information, (4) the tippee knew or should have known that the tipper violated a duty and/or relationship of trust by providing the nonpublic, material information, and (5) the tippee benefited from the disclosure of information. Tippers and tippees can both be liable.[10]

Potential Sources of inside Information

Under the law, there are many sources that may have a duty not to disseminate inside information, some of which may include:

- Corporate insiders – officers, directors, employees;
- Temporary insiders – investment bankers, lawyers, consultants and other advisors;
- Research analysts or portfolio managers;
- Participants in a potential transaction – buyer, sellers,

investors or lenders; and

- Portfolio companies and their potential counterparties, buyers or sellers.

This list is not exclusive; there other non-traditional insiders. In determining who is an insider, courts look at whether a person took on a relationship of trust and confidence. For instance, an insider might be someone who agrees to "come over the wall" and receive confidential information, or a party who did not have a pre-existing duty who later enters into a written confidentiality agreement with respect to information it is receiving. The SEC's Rule 10b5-2 provides more examples of when a duty of trust and confidence exists, such as when someone agrees to keep information silent or there is a history or pattern of sharing confidences.

The most commonly cited examples in case law (noted above) come from the equity side. Some relationships that are more likely to give rise to duties of confidentiality on the debt side include:

- Member of creditor committees (pre- or post-bankruptcy);
- Purchaser of bank debt of a company (theoretically gaining access to the company's performance data);
- Potential lenders to companies involved in an acquisition;[11]
- A rating agency employee;[12] or
- More generally, an analyst, any time he or she is asked to "come over the wall" and receive confidential information; if the analyst agrees, under certain circumstances, the requisite duty is created.

Again, these are just some of the sources. More recent cases, discussed below, suggest that the SEC is interested in expanding and testing the limits of what constitutes an "inside" source.

Types of Insider Trading Cases Concerning Debt Securities and Credit

In recent years, the SEC has brought enforcement actions aimed at alleged insider trading in debt instruments. As a result, it is worthwhile to examine these cases in order to identify red flags – specifically, sources of material, nonpublic information, mentioned above in the second part of this article – in the trading of derivatives, distressed debt, government bonds and bank loans. In short, for the hedge fund professional, these cases help identify potentially problematic tippers or tippees.

Derivatives: SEC v. Rorech

SEC v. Rorech is a bond derivatives (specifically CDS) case in which the source of inside information was a "temporary insider." In *Rorech*, the SEC brought an action against a Deutsche Bank bond salesman who gave a hedge fund manager (Millennium Partners) information on a high yield bond offering in the making. Deutsche Bank was to finance the acquisition of VNU and retire VNU's existing high yield bonds. Someone who knew this could have bought a CDS[13] on the soon-to-be retired VNU bonds and profited handsomely and quickly. Millennium Partners did just that and made $1.2 million buying a CDS covering $20 million in VNU high yield bonds, just before they were retired.

The SEC's complaint survived Rorech's motion to dismiss, made on various grounds,[14] but the SEC ultimately lost at trial.[15] The SEC's *allegations* about the nature of the tips were sufficient to survive early dismissal, but the evidence at the trial was not persuasive. First, the court held that the "tip" provided by the salesman did not constitute a nonpublic material fact, but rather the salesman's own speculation upon which an insider trading claim could not be based.[16] Second, the court held that the tipper had no duty of confidentiality to VNU, Deutsche Bank, or anyone else,[17] as Deutsche Bank had taken no steps to ensure the confidentiality of the information at issue.[18] Finally, the court found that there had been no deception, as required by Rule 10b-5; the bond salesman did not try to hide what he was doing from his superiors.[19]

The case generated various reactions among attorneys and legislators. Perhaps as a result of the case, the SEC promulgated a new rule pursuant to the Dodd-Frank Act indicating clearly that swaps, such as CDSs, are securities for purposes of a securities fraud claim. While the rule generally applies to fraud involving CDSs, it explicitly applies to insider trading and CDSs.[20]

Many things could be said about this case. For the SEC, the case appeared to be an indirect response to the subprime mortgage crisis, which involved CDSs. The case also appeared to be a test by the SEC of the limits of its enforcement power to reach certain, more exotic products (debt-based instruments, like CDS) and defendants (hedge fund tippees).

More than anything else, the case may give hedge funds pause before accepting advice from bond salesmen from investment banks, especially if the hedge funds have any reason to believe that its investment banks are passing information learned in their role as "temporary insiders." While the SEC ultimately lost this case, the process was still costly for the defendants. And while the SEC seems not to have filed any other complaints alleging insider trading of CDSs or other structured products, the case may cast a shadow on the practice of trading on such tips.

Bankruptcy & Distressed Debt: The Barclays Settlement

Another source of inside information in a recent SEC settlement was a trader who sat on various bankruptcy creditor committees of distressed companies. In 2007, somewhat before the collapse of the subprime mortgage-backed securities market, the SEC settled claims against Barclays, which was accused of actively trading bonds in companies while the head of Barclays' proprietary distressed bond trading desk sat as a member of the bankruptcy creditor committees of the same companies.[21]

The settlement stated that over eighteen months, Barclays and the trader bought and sold millions of dollars of securities while aware of material nonpublic information received through six creditor committees. Neither the trader nor Barclays ever informed their counterparties on the trades that they had access to material, nonpublic information.

Notably, in reaching a settlement with the SEC, the "big boy" letters (agreements not to sue over non-disclosure of material nonpublic information) Barclays executed with its counterparties did not insulate Barclays from liability from an SEC suit.[22] The SEC had brought similar cases before the Barclays settlement,[23] but it appears not to have made public its pursuit of similar distressed debt cases since Barclays despite the uptick in bankruptcy filings since 2008.

Government Bonds

One possibly surprising source of inside information is the government itself – at least when it embargoes certain information for a limited time. In *SEC v. Nothern*,[24] certain defendants violated a press embargo imposed by the Treasury Department in announcing the suspension of sales of 30-year bonds. These defendants purchased 30-year Treasuries just before the announcement of their suspension boosted their price. The SEC pursued and settled actions against the tipper as well all the other tippees, including Goldman Sachs and Massachusetts Financial Services, in 2003.[25] One other tippee settled and pleaded guilty to criminal charges.[26]

Nothern, a mutual fund manager at Massachusetts Financial, was the sole defendant left. His summary judgment motion was denied because "the SEC . . . proffered sufficient evidence from which a reasonable jury could conclude that Davis [the individual who misappropriated the Treasury Department information that was subject to a news embargo] had a fiduciary duty or similar relationship requiring him to maintain the confidentiality of the embargoed information with respect to the 30-year bonds."[27] Nothern later lost a jury trial in July 2009 under the misappropriation theory of insider trading and thereafter settled with the SEC.[28]

Bank Loans Purchased or Sold by Hedge Funds

Another area where regulators may focus is on those who trade on one potential source of inside information – that is, information obtained through the purchase of bank debt. One article speculates that syndication and distribution of bank loans could lead them to be considered "securities" in a manner previously rejected by courts, such that they would be subject to insider trading laws:

> The SEC's new enforcement focus, coupled with the fragile legal underpinnings of the market's current assumption that bank loan assets are not "securities," means that participants in the bank loan asset marketplace may be exposed to significant risk of litigation by the SEC or private plaintiffs. These risks are heightened by substantial disparities among market participants in their access to and use of material, nonpublic information regarding issuers.[29]

Practical Steps for Hedge Fund Managers

Hedge funds are in a very unusual position in this arena. By their very nature, hedge funds are supposed to "ferret out and analyze information" about companies and products that no one else knows.[30] But such information may be nonpublic and/or material, and as the cases above in the third part of this article demonstrate, hedge funds must take care to make sure their sources are not providing nonpublic or material information, in violation of relevant duties, in the context of buying or selling debt securities.

Hedge fund managers must have compliance policies and procedures concerning insider trading put in place before any situations arise involving trades in debt securities based on material, nonpublic information. Managers should implement rules and practices to ensure that analysts and portfolio managers are trained regarding sources of inside information and can identify the situations that may give rise to insider trading issues, including situations such as those in the cases discussed above. Hedge fund managers should also teach their employees to notify their supervisors and compliance and legal departments whenever they believe that material, nonpublic information has been received.

But even with such policies in place, and because of the nature of the business, hedge fund managers are likely at some point to come into possession of material and/or nonpublic

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information, as shown in the cases above. The question is what to do then.

In such a situation, the analyst, the compliance department and the legal department (in-house and outside) should review information and its source in light of the appropriate insider trading theory (classic or misappropriation). If it appears that the information is material, nonpublic and was provided in breach of relevant duties, then the firm must decide to either disclose the information publicly, or abstain from making trades based on that information.

In most debt trading scenarios, disclosure would raise timing, coordination, strategic or legal issues, and abstention may be a more practicable option. For example, the hedge fund in the role of "tippee" for an as-yet unannounced transaction may consider waiting for the actual companies involved to make an announcement before making such a disclosure. Also, some information may need to be disclosed by the issuer pursuant to Regulation F-D. The manager may also contact the companies involved about making the disclosure themselves, but the companies may have other reasons to disclose or not disclose, or to select the timing of disclosure.

It is easy for lawyers and SEC enforcement officials, who sit far away from trading desks, to judge that information is "inside." It is harder to make this call in real time from the hedge fund trenches, in the fast-moving debt markets. However, even if those in the trenches – the analysts and the traders – might be tempted to proceed with a trade, they should still consider the costs of risking insider trading liability. While abstaining from a trade can be costly, a criminal or civil prosecution for insider trading can have very serious consequences for the manager and its employees. Criminal enforcement by the DOJ may entail jail time for individuals, fines, criminal forfeiture, loss of licenses and being put out of business. Civil regulatory enforcement through the SEC can devastate a manager, with sanctions that can include bars from the industry, fines, other civil money penalties and forfeiture, often at a multiple of the amount of gained on a single trade based on inside information. Finally, private parties can still seek damages. Often, the ultimate penalty for being caught can dwarf the size of the original gain. While the life of a hedge fund professional is fast-paced, it is worth the additional time to consult with a compliance or legal professional (in-house or otherwise) to avoid trading on mysterious tips.

One final irony: the implosion of the market for subprime mortgage-backed bonds, and later the general market crash in 2008, may have been catalysts for increased SEC enforcement of insider trading in debt markets, even if insider trading played little role in precipitating those events. Arguably, the information that helped those, like Paulson, win big on subprime was public and in plain view.

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[1] Michael Lewis, *The Big Short: Inside the Doomsday Machine* (2010).
[2] See The Asset Allocation Advisor, World Stock and Bond Markets and Portfolio Diversity, Values of the World Stock and Bond Markets, 2009, available at: http://www.aametrics.

com/pdfs/world_stock_and_bond_markets_nov2009.pdf.

[3] See Craig Karmin, "Hedge Funds Do About 30% Of Bond Trading, Study Says," The Wall Street Journal, Aug. 30, 2007, available at: http://online.wsj.com/article/SB118843899101713108.html.

[4] Hill, "Official Says Division Continuing To Mine Cases From Credit, Mortgage Crisis," 41 Sec. Reg. & L. Rep. 2216 (Dec. 7, 2009) (quoting SEC Associate Director of Enforcement's statements regarding efforts "to devote a lot of resources to combating hedge fund insider trading and insider trading by Wall Street . . . .").

[5] See "SEC Names New Co-Chiefs of Enforcement Division Asset Management Unit and Other Specialized Unit Chiefs," The Hedge Fund Law Report, Vol. 3, No. 3 (Jan. 20, 2010).

[6] Remarks at Oct. 16, 2009 Press Conference by Robert Khuzami, Director, SEC Division of Enforcement, available at: http://www.sec.gov/news/speech/2009/spch101609rk.htm. See also Khuzami's Remarks at Nov. 5, 2009 Press Conference, available at: http://sec.gov/news/speech/2009/spch110509rk.htm (announcing expanded civil charges in the Galleon matter and other insider trading charges).

[7] Roben Farzad and Theo Francis, "The SEC's Tough New Offensive on Insider Trading," Business Week, Oct. 21, 2009), available at: http://www.businessweek.com/magazine/content/09_44/b4153000978323.htm.

[8] See *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

[9] See *Dirks v. SEC*, 463 U.S. 646 (1983).

[10] See *United States v. O'Hagan*, 521 U.S. 642, 652-53 (1997).

[11] In certain instances, courts have held that there are no duties. See, e.g., *SEC v. Nelson J. Obus et al.*, 06-Civ.-3150 GBD, 2010 WL 3703864 (S.D.N.Y. Sept. 20, 2010) (dismissing insider trading claims against partners in a hedge fund because the potential lender was in an arms-length relationship with the company). See also "SEC's Insider Trading Case Against Nelson Obus of Hedge Fund Wynnefield Capital Thrown Out on Summary Judgment Motion Because SEC Failed to Prove that GE Capital Tipper Acted Deceitfully or in Violation of a Confidentiality Duty," The Hedge Fund Law Report, Vol. 3, No. 38 (Oct. 1, 2010).

[12] See *SEC v. Hardin*, 10-Civ.-08600, 2010 WL 4778590 (S.D.N.Y. Nov. 12, 2010) (complaint alleging that tippee received material nonpublic information from a Moody's analyst involved in evaluating the company being acquired).

[13] A credit default swap is a kind of insurance policy on an underlying bond in which the buyer pays a steady premium during the life of the bond to the seller, who must pay the full value of the debt instrument in the event that it defaults or, in some instances, declines in value beyond a certain amount.

[14] See "SEC's First-Ever Credit Default Swap Insider Trading Case Survives Motion to Dismiss," The Hedge Fund Law Report, Vol. 2, No. 51 (Dec. 23, 2009).

[15] See *SEC v. Rorech*, 673 F. Supp. 2d 217, 227-28 (S.D.N.Y. 2009). See also "After Bench Trial of First-Ever Credit Default Swap Insider Trading Action, U.S. District Court Rules that Swaps Referencing Bonds Are 'Securities-Based Swap Agreements' Under Antifraud Provisions of Securities Exchange Act, but Holds that SEC Failed to Prove Insider Trading," The Hedge Fund Law Report, Vol. 3, No. 27 (Jul. 8, 2010).

[16] 673 F. Supp. 2d at 411.

[17] Id. at 413.

[18] Id.

[19] Id. at 416.

[20] See "Proposed Rule: Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps," SEC Release No. 34-63236 (Nov. 3, 2010).

[21] See "Barclays Bank Pays $10.9 Million to Settle Charges of Insider Trading on Bankruptcy Creditor

Committee Information," SEC Litigation Release No. 20132 (May 30, 2007).

[22] See id. The validity of so-called "big boy letters" as between counterparties was not tested in the Barclays settlement.

[23] See, e.g., *SEC v. Sherman N. Baker*, 93-Civ.-7398 (RWS), SEC Litigation Release No. 13850, 55 S.E.C. Docket 823, 1993 WL 441385.

[24] 598 F. Supp. 2d 167 (D. Mass. 2009).

[25] See "SEC Brings Enforcement Action against Three Individuals, Goldman Sachs, and Massachusetts Financial Services Company Related to Trading Based on Nonpublic Information about the Treasury's Decision to Cease Issuance of the 30-Year Bond," SEC Litigation Release No. 18322 (Sep. 4, 2003).

[26] See "Former Goldman Economist Youngdahl Agrees to Fraud Injunction and $240,000 Penalty in SEC Treasury Bond Insider Trading Case," SEC Litigation Release No. 18453 (Nov. 12, 2003).

[27] 598 F. Supp. 2d at 177.

[28] See "SEC Secures Settlement with Former Mutual Fund Manager, Steven A. Nothern, Following a Federal Jury's Verdict," SEC Litigation Release No. 21389 (Jan. 22, 2010).

[29] Christopher G. Green & Heather B. Sanborn, "Increasing Litigation Risks for Bank Loan Market Participants," 20 Sec. Litig. J. (ABA Section on Litigation, Fall 2009).

[30] *Dirks*, 463 U.S. at 658.