The Ominous Meaning of the Rajaratnam Insider Trading Case

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Make no mistake about the recent barrage of news regarding insider trading enforcement—what was old is new again and we can expect several more high-profile cases in the weeks and months to come. Just as the 1980s saw Wall Street brought to ground by insider trading cases (Dennis Levine, Ivan Boesky and Michael Milken), expect the current regime at the SEC and the Department of Justice to attempt to make a similar impact by pursuing today's insider trading targets with the same intensity and vigor.

Wayne Gross

Yet the Government's current prosecutorial insider trading endeavors are even more aggressive. The SEC and D0J have shifted their focus from "traditional" insider trading to a "misappropriation" theory that seeks to criminalize "outsider trading" by non- insiders who have routine access to material, non-public information from Wall Street. Such enforcement can be quite problematic if extended too far. It appears that it may become increasingly difficult for both "insiders" and "outsiders" with access to corporate information to determine the appropriateness and use of non-public information.

Securities and Exchange Commission v. Galleon Management, LP et al

In mid-0ctober 2009, Raj Rajaratnam, founder of Galleon Group, was arrested on thirteen counts of conspiracy and securities fraud stemming from an alleged insider trading scheme that netted over $20 million. Executives from IBM, Intel Capital, McKinsey & Company, and New Castle Funds LLC were also arrested. The purported fraud involved the stocks of companies such as Google, Inc., Hilton Hotels Corporation, Advanced Micro Devices, Inc., Clearwire Corporation, Akamai Technologies, Inc., Polycom, Inc., and PeopleSupport, Inc. Based upon the criminal complaints filed and what has been reported thus far, it appears that hedge fund managers, corporate executives. analysts, lawyers and others may have traded tips in exchange for money or other information. According to Robert Khuzami, Director of the SEC's Division of Enforcement, Mr. Rajaratnam "cultivated a network of high-ranking corporate executives and insiders, and then tapped into this ring to obtain confidential details about quarterly earnings and takeover activity."

Mike Piazza

After the arrest of Mr. Rajaratnam, Mr. Khuzami revealed that the SEC is developing a variety of initiatives to monitor hedge fund activities that involve "greater specialization and expertise, improved technological tools to track and analyze trading, better coordination among regulators and law enforcement, new legislative initiatives, and other means to address these areas. It would be wise for investment advisors and corporate executives to closely look at today's case, their own internal operations, and the increasing focus and scrutiny on hedge fund trading activity by the SEC and others, and consider what lessons can be learned and applied to their own operations."

Lessons learned from the Galleon case

The criminal case involving the Galleon Group reveals that the SEC and D0J are not at all hesitant to use the "misappropriation" theory of insider trading. Both the "traditional" and "misappropriation" theories of insider trading seek to prevent the use of material, non-public information in the purchase or sale of securities. Each does so, however, from a different vantage point. The "traditional" theory targets the breach of duty a corporate insider owes to shareholders. The "misappropriation" theory targets the breach of duty an outsider owes to the source of the information. And at times, the duty an outsider, such as a money manager, owes is less than crystal clear; also often less than clear is whether the outsider intentionally misappropriated the information. For example, in the case against Mr. Rajaratnam and his co-defendants, information was not always exchanged for cash; at times it was exchanged for other tips and even for the promise of unspecified future favors. What this means is that it may not always be easy for "insiders" and "outsiders" to know with precision when and how non-public information may be discussed and used.

Donald Bunnin

Equally troubling is the fact that the Government pursued the Galleon case like a mob or political corruption investigation rather than an insider trading investigation. Rather than relying on a pattern of illegal trades after the fact, the investigation relied upon the surreptitious tape-recording of Mr. Rajaratnam by a cooperating informant. This means that the Government for the first time in a major insider trading case was able to get what appear to be quite damaging admissions from the target on tape.

Finally, the Government, rather than preventing unlawful trades from happening in the first instance, allowed illegal trading to take place so that they could monitor the suspects under investigation. This too is a deviation from the historical way in which the SEC and D0J traditionally stepped in to stop insider trading transactions before they happened to protect the markets.

What businesses can and should do to protect themselves

The Galleon Group case, coupled with the statements of Mr. Khuzami, make clear that that the increased enforcement efforts by the SEC and DOJ are profound. While the current focus appears to be hedge funds, the fallout from the Rajaratnam case is already being felt in executive suites and board rooms around the country, in no small part due to the "other parties" who have also been charged, including corporate executives who served as alleged sources of information to Galleon. Because the stakes are high and Government resources are at an all-time peak (both in dollars and manpower available) to seek enforcement of potential insider trading, anyone involved with a public company should be aware of and sensitive to the current climate and enforcement methods. Companies must ensure that adequate and unambiguous insider trading policies are in place and that all employees are provided with such policies. If such policies are violated and questionable information trading appears to have taken place, companies should consider conducting an internal investigation by appropriate outside counsel.

Such actions can make the difference between avoiding government scrutiny in the first instance and getting ensnared in an enforcement action or worse.

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