

SEC widens insider-trading net

With high-profile case, lawyers and others become potential targets

By David E. Frank

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When the U.S. Securities and Exchange Commission filed federal fraud charges against the powerful New York hedge fund Galleon Management and its billionaire owner, officials seized the opportunity to issue a warning to those working in the industry.

"Today, tomorrow, next week, the week after, privileged Wall Street insiders who are considering breaking the law will have to ask themselves one important question: Is law enforcement listening?" U.S. Attorney Preet Bharara, of the Southern District of New York, said at a recent press conference. He added that the case should serve as a "wake-up call" for hedge-fund managers, traders and corporate executives around the country.

In the wake of the charges against Galleon, which has sparked the largest insider-trading case in U.S. history to date, white-collar lawyers in Massachusetts say the government is casting an increasingly wider net in enforcing securities fraud.

The high-profile charges, which implicated 21 defendants including a Westwood hedge-fund manager and two associates from Ropes & Gray's New York office, have had a ripple effect on securities professionals in the commonwealth.

"The case has drawn a lot of attention here because it doesn't strictly involve the kind of Wall Street players we typically see in an insider-trading investigation," said Timothy W. Mungovan, who practices in Nixon Peabody's commercial litigation department in Boston. "You're talking about people at major law firms, leading corporations and consulting firms who could just as easily be working here as opposed to Wall Street."

Although the courts have long held that an individual can be liable for misappropriating confidential material, Matthew N. Kane, of Donnelly, Conroy & Gelhaar, said the Galleon case shows that

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— Matthew N. Kane, Boston



the SEC has decided "to expand the goalposts" for establishing what constitutes insider trading.

"People in the hedge-fund industry have always understood that they have some responsibility," the Boston lawyer said. "But looking at *Galleon*, there is a new recognition and understanding of just how expansive that duty can be."

Tough questions

Kane said the most difficult question lawyers are being asked post-*Galleon* is where to draw the line between permissible exchanges of information that form the basis

for everyday trades, and illegal insider trading that can lead to severe civil and criminal penalties.

"That line is very gray, and it is getting increasingly grayer," Kane said. "The thing that you can do is set up a process to deal with the questions when they inevitably arise, but I don't think anyone can set up a program at this point that gives absolute answers under any circumstances."

Where securities laws do not provide an express definition of insider trading, its meaning has evolved over the years on a case-by-case basis, Kane said. In general, the term has been defined as the buying or selling of a security in violation of a

fiduciary duty while in the possession of material, non-public information.

But part of what has made *Galleon* noteworthy, Kane said, is the government's new, expansive theory that "anyone who knew or should have known

they were receiving information in breach of a duty, even if they themselves did not owe a duty," can now be on the hook under Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5.

The group of potential wrongdoers who can be impacted includes attorneys, consultants, underwriters and hedge-fund traders.

"I think we've all seen that there are new questions being raised and new things happening because of *Galleon*," Kane said. "In the end, some of this will turn out to be good for everyone because it's prophylactic. People are making sure that they are doing

the right things now who might not have ever thought that they even had a duty.”

Sweeping allegations

In October 2009, the SEC filed a civil injunction in U.S. District Court in New York against Raj Rajaratnam and his hedge-fund advisory firm, Galleon Management, alleging they had engaged in a massive insider-trading scheme that illegally generated more than \$25 million.

The SEC, and eventually the Department of Justice, charged a large group, including executives at IBM, Intel Capital and two intellectual property associates from the New York office of Ropes & Gray, with misappropriating material, non-public information.

In its complaint, the government claimed that Rajaratnam had tapped into his network of friends and business contacts to obtain insider tips and confidential information about corporate earnings and takeover activity at companies such as Google, Hilton and Sun Microsystems.

Relying on more than 2,400 wiretapped phone recordings, which are now the subject of a defense motion to suppress, the government accused Rajaratnam of using

the information to illegally trade on behalf of Galleon.

Although Rajaratnam has denied the allegations, more than half the defendants charged, including Ropes & Gray's Brien Santarlas, have admitted to wrongdoing.

Last week, a judge in New York entered a consent order and judgment against a defendant accused of acquiring and passing on to Rajaratnam information he had obtained while working as a consultant at McKinsey & Co.

A spokesman for Rajaratnam declined to comment, as did the SEC.

Tapping into the evidence

Thomas M. Hoopes, of Boston's LibbyHoopes, said the Galleon case has drawn a lot of attention, in part, because it marks one of the first times the government has used wiretaps in a securities case. Such investigatory tools, he said, are usually reserved for drug cases, RICO matters and more traditional organized-crime prosecutions.

“If they are going to start using them in this kind of a case where you are investigating a tip, then there are a lot of cases out there that can be made,” Hoopes

said. “The question is how proactive is the Boston office [of the SEC], and some of the others, going to be?”

Hoopes added that wiretaps can clearly be relevant in proving intent, which is typically one of the most difficult elements of an insider-trading prosecution.

“With such a cutting-edge case like *Galleon*, [the government] clearly wanted to be in a position where they were shooting to kill and not just relying on one witness's word against another,” Hoopes said. “They wanted to have the words on tape.”

Allison D. Burroughs, of Nutter, McClennen & Fish in Boston, added that wiretaps are resource intensive and expensive. In order to get one, the former federal prosecutor said, the government must make a showing of necessity. One of the elements of necessity is that there cannot be any other way to obtain the evidence.

“In most white-collar cases, there is generally a paper trail that makes it harder to get a wiretap,” she said. “The fact that [the government] viewed an insider-trading investigation to be big enough to warrant one here is obviously very significant.”

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