August 7, 2007

SEC – INVESTMENT FUNDS ALERT

SEC FORMS WORKING GROUP TARGETING INSIDER TRADING IN THE HEDGE FUND INDUSTRY

On July 31, 2007, while testifying before the Senate Banking, Housing and Urban Affairs Committee, SEC Chairman Christopher Cox unveiled the creation of a new "working group" designed to "coordinate and enhance [the SEC's] efforts to combat hedge fund insider trading." The SEC's new hedge fund working group is the latest in a series of public initiatives by the agency to increase its oversight of the hedge fund industry. The perceived problem that the working group seeks to address – insider trading by hedge funds – has also been the subject of media speculation, and in certain instances Congressional attention, for some time. For example, in May 2007 the *New York Times* ran an article entitled "Suspicious Trading On the Rise," which made the following observation: "At the same time that deals and the number of people involved in deal-making have increased, the number of hedge funds has surged, with their traders looking for any competitive edge in information. As a result, the potential, and temptation, for information to be leaked is substantial." Media reports such as these have been fueled by several recent high profile insider trading scandals, some of which were cited by Chairman Cox during his Senate Committee testimony.

In particular, Chairman Cox discussed cases where hedge funds allegedly traded on non-public merger and acquisition information, cases where hedge funds were alleged to have engaged in short-selling based on inside information about private investment in public equity ("PIPE") offerings, an alleged scheme where hedge fund portfolio managers received illegal tips about analyst upgrades and downgrades, and a scheme where a small family-run hedge fund allegedly executed a series of profitable options transactions based on inside information that the family patriarch had misappropriated from his employer. In addition to being sued by the SEC, many of the defendants in these cases were prosecuted criminally by the U.S. Attorney's Offices in the Southern and Eastern Districts of New York. The SEC's hedge fund working group appears to signal a concerted effort by the agency to coordinate and focus its enforcement efforts in these types of cases on a nation-wide basis.

In addition to media attention on hedge fund insider trading, Congress has expressed its concerns regarding SEC enforcement efforts in this area. For example, a recent Congressional report criticized certain of the SEC's hedge fund investigation efforts. In response to that criticism, Chairman Cox emphasized the creation of the working group as demonstrating the agency's strengthened commitment to prosecuting insider trading.

OVERVIEW

The SEC's hedge fund working group was actually formed by a group of attorneys and examiners in the agency's New York Regional Office over a year ago. Chairman Cox's announcement refers to the group's recent expansion to the SEC's home office in Washington, D.C., and its various regional offices throughout the country. The group is still coordinated, however, out of New York.

Contrary to certain media reports, the working group is not a specialized unit of SEC attorneys and investigators dedicated solely to investigating potential insider trading violations by hedge funds. Instead, the group is organized as follows. Each SEC office has a core team of attorneys, investigators and examiners who represent and manage the working group for their respective regions. The group focuses primarily on insider trading, but also keeps track of any novel issues that arise in the hedge fund arena. SEC staffers familiar with the working group have described its primary goals as follows: (1) educate the SEC's staff on hedge funds and how they operate; (2) coordinate all of the SEC's ongoing hedge fund investigations throughout the United States; and (3) share information within the SEC about both ongoing investigations and recent trends regarding hedge funds and insider trading.

To further these goals, the group hosts regular internal meetings where SEC staff members from different offices are encouraged to share information. The group also routinely circulates email bulletins throughout the SEC to keep the agency's staff up to date on recent issues and trends related to hedge funds and insider trading law. The working group is clearly designed to encourage the SEC's entire staff, as opposed to just group members, to investigate and bring enforcement actions against hedge funds who appear to have run afoul of the insider trading laws.

Chairman Cox also noted in his Senate Committee testimony that the hedge fund working group was focused on coordinating with "other federal law enforcement agencies and self-regulatory organizations." SEC staff members familiar with the working group have confirmed that this is an important aspect of the group's mandate. These other agencies include the Commodity Futures Trading Commission, the New York Stock Exchange ("NYSE"), the National Association of Securities Dealers ("NASD"), and various U.S. Attorney's Offices throughout the country. With respect to SROs, such as the NYSE and the NASD, the working group is likely to encourage these organizations to step up their efforts to conduct market surveillance aimed at identifying suspicious trading patterns that could result in new insider trading investigations. Referrals from SROs are a significant source of SEC insider trading cases and as of Spring 2007 the number of cases referred to the SEC was reportedly well ahead of the rate of referrals from 2006. SEC staff members have confirmed that the group is examining how technology can be improved and better utilized in the market surveillance area. SRO officials have also publicly stated that their organizations have been expanding their market surveillance techniques to detect especially sophisticated forms of insider trading involving, for example, stock options, derivatives, bonds, onshore and offshore trading, and the use of multiple accounts. With respect to the criminal authorities in general, and the Department of Justice in particular, there is a long history of close cooperation with the SEC. The working group appears to be attempting to build on this foundation by working with the criminal authorities to develop evidence that will not only result in civil enforcement actions, but also criminal insider trading charges against hedge funds and their employees.

CONCLUSIONS

The SEC's decision to expand its hedge fund working group is a sign that the agency is trying to lead a charge to combat the perceived problem of "hedge fund insider trading." The working group will no doubt encourage the agency's enforcement staff to open more investigations in this area and its hedge fund examination staff to scrutinize hedge funds more closely for evidence of potential insider trading violations. While insider trading cases against sophisticated investors, such as hedge funds, who often employ complex trading strategies have historically been difficult to develop, the working group may succeed in creating more sophisticated SEC investigators who are better equipped to uncover complex insider trading schemes that go beyond simple equity trading. SEC staffers with a better understanding of the hedge fund industry will also hopefully be able to separate truly problematic trading patterns from legitimate transactions that might arouse the suspicions of less experienced investigators. If this is the case, hedge funds should be able to minimize their chances of being embroiled in drawn out insider trading investigations, or worse yet misguided enforcement actions, by developing strong policies and procedures designed to document legitimate investment decisions and guide traders and portfolio managers from engaging in impermissible conduct.

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