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INVESTMENT FUNDS ALERT

COURT ENDORSES NOVEL PROSECUTION APPLYING INSIDER TRADING LAWS TO HEDGE FUND MANAGERS SEEKING TO REDEEM PERSONAL INVESTMENTS

In June 2008, the U.S. Attorney's Office for the Eastern District of New York (EDNY) unsealed a securities fraud indictment against former Bear Stearns hedge fund managers Ralph Cioffi and Matthew Tannin. The charges were highly publicized, having been announced in the wake of the collapse of Bear Stearns itself. At bottom, the government alleges that Cioffi and Tannin lied to investors about the current performance and future prospects of the funds, which were heavily invested in securitized instruments that were at the heart of the credit crisis. Included in the indictment, among a series of more-straightforward fraud charges, is a single count of insider trading against Cioffi based on his redemption of a personal investment in one of the Bear Stearns funds (the "Fund") while allegedly in possession of material, non-public information about the Fund's performance and prospects.

Unlike other aspects of the case, the Cioffi insider trading charge has not been the subject of much public scrutiny. The charge is unusual—and perhaps unique—for a number of reasons. It appears to be the first time the government has attempted to apply the insider trading laws to private transactions involving investment interests in a hedge fund. Also of note is the fact that the SEC did not include any similar insider trading allegations in its parallel civil complaint. This is surprising, since the SEC is subject to a lower burden of proof when establishing a civil violation (i.e., a "preponderance of the evidence") than the standard to which the EDNY will be held in its criminal case (i.e., "beyond a reasonable doubt").

Cioffi filed a motion to dismiss the insider trading charge, but, on July 14, 2009, Judge Frederic Block denied this motion, thereby endorsing the government's effort to expand insider trading law to cover individuals seeking to redeem their investments in a private hedge fund. The basis for Judge Block's decision is not entirely clear, since he ruled from the bench and has not issued a written opinion. A review of the defense's motion papers and the government's response, however, sheds light on the key legal issues that were in dispute.

To establish insider trading liability, the government must prove that the defendant purchased or sold a security while in possession of material, non-public information in breach of a fiduciary or similar duty. The defense argued that, as a hedge fund manager, Cioffi only owed a fiduciary duty to the Fund and not to the individual investors who had placed money in the Fund.[1] The defense

[1] The defense relied on *Goldstein v. SEC*, 451 F.3d 873, 880 (D.C. Cir. 2006), where the Court of Appeals for the D.C. Circuit recognized that a fiduciary relationship "exists between the adviser and the fund, but not between the adviser and the investors in the fund."

contended that, since the Fund had the same information that Cioffi did, there was no deception and, therefore, no securities fraud.

The government response was that Cioffi's duty to the Fund required him either to abstain from redeeming or to first disclose to the Fund's independent directors both his intention to redeem and any material information about the Fund of which they were unaware. The government further argued that Cioffi did, in fact, owe a duty to the Fund's investors and that his failure to make similar disclosures to those investors before redeeming amounted to fraud.

The defense also argued that the insider trading count should be dismissed because Cioffi's redemption was not a purchase or sale of securities. The government's briefs did not clearly respond to this argument, but it appears that they were of the view that the redemption was a sale to the Fund.

While the court's rationale for refusing to dismiss the insider trading count against Cioffi is unclear, the fact that the government is being permitted to go to trial on this novel theory in a criminal case raises complex issues for hedge fund managers who are thinking about redeeming their personal investments. In today's volatile markets, both individual positions and a fund's overall NAV could fluctuate to a material degree on a regular basis. In addition, in the Bear Stearns case, the government has taken the position that the defendants' personal views about their fund's future prospects in the face of the credit crisis constituted material information. Since the standard for insider trading is the "possession" of material, non-public information, even hedge fund managers who want to redeem for reasons that are unrelated to their fund's performance need to carefully consider whether they are aware of material information that has not been disclosed to the fund's entire investor base.

In light of the Cioffi case, hedge fund managers should consult with counsel before making a personal redemption. Depending on the particular facts and circumstances, counsel may be able find ways to help structure redemptions in a manner that minimizes the regulatory risk. For example, in some situations, funds could potentially use trading windows in a manner similar to that of public corporations that allow insiders to trade shortly after they have been "cleansed" of material, non-public information by the dissemination of information to investors. There may also be ways to include helpful language in the fund's offering memorandum and other fund documents regarding how and when the investment adviser's principals intend to redeem any personal investments they have made.

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