WHEN HEDGE FUNDS BETRAY A CREDITOR COMMITTEE'S FIDUCIARY ROLE: NEW TWISTS ON INSIDER TRADING IN THE INTERNATIONAL FINANCIAL MARKETS

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I. Introduction

The near collapse of the financial system in the fall of 2008 because of lax scrutiny of securitized debt instruments necessitates securities regulation reform. It is essential that lawmakers are mindful of the role of hedge funds in magnifying the impact of the crisis through their heavy investment in alternative high-risk instruments and erstwhile inclinations to engage in market manipulation. The reform must address both types of market manipulation: fraud and insider trading.

Insider trading is the purchase or sale of a security in breach of a fiduciary duty while possessing material, nonpublic information about the security.[2] Corporate insiders must either abstain from trading securities or disclose any material nonpublic information in their possession prior to trading.[3] Insider trading of stock can

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[2] *See* Chiarella v. United States, 445 U.S. 222, 227-29 (1980) (discussed *infra* note 194 and accompanying text). *See also* U.S. Sec. & Exch. Comm'n, Div. of Enforcement, Insider Trading: Information on Bounties, http://www.sec.gov/divisions/enforce/insider.htm (last visited Oct. 29, 2008).

[3] *See In re* Cady, Roberts & Co., 40 S.E.C. 907 (Nov. 8, 1961). In *Cady, Roberts*, a broker learned that a company was about to reduce its dividends. Prior to the company's public announcement, the broker sold stock in that company for his own account and his customers. *Id.* at 908-09. Writing on behalf of the Securities & Exchange Commission, SEC Chairman Cary held that the broker's transactions violated Rule 10b-5. The SEC reasoned that

undermine investor faith in the fairness of the global capital markets.[4] Insider trading should have "utterly no place in any fair-minded law-abiding economy."[5] For the international capital markets to prosper,[6] the public must have confidence that the securities markets provide a level playing field for investors.[7] Legal restrictions on insider trading are an important part of securities laws regulating the capital markets.[8] Given that new schemes and twists on insider trading transactions continue to arise, the legal concepts encompassed in the prohibition on insider trading must have flexibility to meet challenging, new situations.

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persons with inside information cannot trade with other persons who lack access to that information without first disclosing the material nonpublic information. *Id.* at 914.

[4] Different rationales exist as to why a government should regulate insider trading. *See generally* Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 375-76 (2006); Merritt B. Fox, *Insider Trading in a Globalizing Market: Who Should Regulate What?*, 55 LAW & CONTEMP. PROBS. 263 (1992).

[5] Arthur Levitt, Chairman of the U.S. Sec. & Exch. Comm'n, Address at the "S.E.C. Speaks" Conference, A Question of Investor Integrity: Promoting Investor Confidence by Fighting Insider Trading (Feb. 27, 1998), *transcript available at* www.sec.gov/news/speech/speecharchive/1998/spch202.txt. *See also* Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716 (Aug. 15, 2000).

[6] The international capital markets have used technology to manage the expansive volume of trading of stocks and derivatives that hedge funds help to create. Further expansion of markets is expected after more integration in the world's capital markets through combination of stock exchanges, such as the New York Stock Exchange and Euronext, a European exchange. *See* Christopher Cox, Chairman of the U.S. Sec. & Exch. Comm'n, Speech at the 34th Annual Securities Regulation Institute, Re-Thinking Regulation in the Era of Global Securities Markets (Jan. 24, 2007), *available at* www.sec.gov/news/speech/2007/spch012407cc.htm.

[7] *Chiarella*, 445 U.S. at 241.

[8] Insiders may purchase or sell securities on open markets, but should realize special SEC rules may apply. *See, e.g.*, 17 C.F.R. § 240.10b-18 (2005) (describes a conditional "safe harbor" provision for re-purchasers of equity securities); 17 C.F.R. § 230.144 (exempting certain classes of individuals from being categorized as "underwriters"). For a critical analysis of Rule 144, *see* James P. Jalil, *Proposals for Insider Trading Regulation After the Fall of the House of Enron,* 8 FORDHAM J. CORP. & FIN. L. 689, 715–17 (2003).

Before a public announcement of a major event, such as an impending corporate takeover that is expected to create a significant increase in stock price, insider trading often occurs.[9] Insider trading may also occur prior to announcing negative news for the company, which will decrease the stock price. Insider trading is estimated to affect 25% to 60% of all major stock transactions,[10] with even higher estimates in certain industries.[11] Research indicates similar effects in the options market.[12] The predictability and frequency of insider trading provides a clear need for strong enforcement of the legal prohibitions on insider trading. Organizations must have compliance policies, procedures, and training against insider trading.

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[9] "When an acquisition is announced, the price of the purchasing company typically falls, and the price of the purchased company typically rises." MINORITY STAFF OF S. COMM. ON FINANCE, 110TH CONG., THE FIRING OF AN SEC ATTORNEY AND THE INVESTIGATION OF PEQUOT CAPITAL MANAGEMENT 15 (1st Sess. 2007) [hereinafter PEQUOT REPORT].

[10] Suspicious trading suggesting insider trading occurred in almost sixty percent of transactions related to the largest twenty-seven deals in North America in the first half of 2007. Victoria Kim & Brooke Masters, *Boom Time for Suspicious Trades*, FIN. TIMES, Aug. 6, 2007, at 15. A study for the New York Times found that forty-one-percent of the cases had suspicious trading. Gretchen Morgenson, *Whispers of Mergers Set Off Bouts of Suspicious Trading*, N.Y. TIMES, Aug. 27, 2006, at A1; *see also* Gretchen Morgenson, *Signs of Insider Trading Match Surge in Mergers*, INT'L HERALD TRIB., Aug. 27, 2006, at 1.

[11] Eighty percent of hotel and casino mergers and acquisitions since 2003 included suspicious trading, evidencing insider trading. Victoria Kim, *Abnormal Trading "Ahead of 49% of N. America Deals"*, FIN. TIMES, Aug. 6, 2007 at 19.

[12] *See* Tom Arnold et al., *Do Option Markets Substitute for Stock Markets? Evidence from Trading on Anticipated Tender Offer Announcements*, 15 INT'L REV. FIN. ANALYSIS 247 (2006). The options volume more than doubled in the three days prior to public announcements of large takeovers. David Patch, *SEC's Hedge Fund Dilemma*, STOCKGATE TODAY, May 10, 2007, *available at* http://investigatethesec.com/drupal-5.5/node/87. The options market volume has surged during the last decade, primarily because of investment by hedge funds, improvements in technology, and the evolving regulatory oversight easing investor concerns. Sarah Rudolph, *Institutions Drive Options Volume Skyward,* TRADERS ONLINE, July 15, 2007, http://www.traders magazine.com/issues/20070715/2873-1.html.

In 2007, the SEC recognized that "insider trading" of securities has become "rampant" among Wall Street professionals[13] and that sophisticated concealment of insider trading had increased.[14] For example, in one recent insider trading case, the parties used disposable cell phones, secret codes, and discreet meeting places to try to cover their illegal activities.[15] The complexity of insider trading cases continues to increase because of new methods to conceal insider trading on material nonpublic information throughout the intertwined global financial markets.[16] Liberalization of international financial markets has also created new opportunities for insider trading.

Other reasons besides concealment make government investigations challenging to conduct.[17] First, insider trading cases are usually disputes over facts rather than law.[18] Such cases usually

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[13] Rachelle Younglai, *U.S. SEC Sees "Rampant" Insider Trading On Wall St.*, REUTERS, Oct. 25, 2007, http://www.reuters.com/article/newsOne/idUKN2558382320071025.

[14] *See Examining Enforcement of Criminal Insider Trading and Hedge Fund Activity: Hearing Before the S. Comm. on Judiciary*, 109th Cong. (2006) [hereinafter *Insider Trading Hearing*] (statement of Linda Chatman Thomsen, Director of Enforcement, U.S. Securities and Exchange Commission). "The investigation of insider trading activity normally follows a public announcement of information which materially affects the price of the issuer's security. Large trades beyond the parameters of normal trading activity [raises suspicion]." MICHAEL J. WATSON, THE REGULATION OF CAPITAL MARKETS: MARKET MANIPULATION AND INSIDER TRADING 14, www.icclr. law.ubc.ca/Publications/Reports/wats_pap.pdf (last visited Nov. 21, 2008).

[15] *See Insider Trading Hearing*, *supra* note 14 (statement of Linda Chatman Thomsen).

[16] A new concern exists that corporate executives sometimes strategically manipulate their corporation's release of major news shortly after the dates providing stock option grants. *See* Maureen McGreevy, Insider Waiting: The New Loophole Under 10b5-1 13, *available at* http://works.bepress.com/cgi/viewcontent.cgi?article=1000&context=maureen_mcgreevy (last visited Nov. 2, 2008).

[17] During the last decade, the SEC and the stock exchanges have increased their sophistication in detecting insider trading. The stock exchanges perform primary surveillance for insider trading using cutting edge software programs to detect unusual trading activity. *Insider Trading Hearing*, *supra* note 14, at 4 (statement of Linda Chatman Thomas) .

[18] Reg. FD prohibits intentional disclosure of inside information to selective outsiders. SEC General Rule Regarding Selective Disclosure, 17 C.F.R. §

involve multiple parties.[19] Second, direct evidence clearly showing insider trading is unusual.[20] Evidence of insider trading mostly consists of circumstantial evidence that requires examining "inherently innocuous events . . . and drawing reasonable inferences based on their timing and surrounding circumstances to lead to the conclusion that the defendant bought or sold stock with the benefit of inside information . . . ."[21] Thus, it is often difficult for the government to acquire sufficient evidence to prosecute an insider trading case.[22] Instead, prosecutions arising from insider trading

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243.100 (2007) However, Reg. FD also requires prompt public disclosure after any inadvertent selective disclosure. *Id.* Reg. FD does not apply to disclosure of material nonpublic information to temporary insiders. Selective Disclosure and Insider Trading, Securities Act Release No. 7787, Exchange Act Release No. 42,259, Investment Company Act Release No. 24,209, 71 SEC Docket 732 (Dec. 20 1999) (explaining that disclosures to "temporary insiders" are exempt from Reg. FD since such persons "are bound by duties of trust and confidence not to disclose or use the information for trading."). C*f.* Investment Advisers Act of 1940 § 204A, 15 U.S.C. § 80b-4(a) (2000).

[19] *See* Mary M. Caskey, *Lifting the Fog: Finding A Clear Standard of Liability for Secondary Actors Under Rule 10b-5*, 41 VAL. U. L. REV. 403, 417 n. 70 (2006).

[20] "Unless the insider trader confesses his knowledge in some admissible form, evidence is almost entirely circumstantial. It requires examining the facts, including inherently innocuous events, as pieces of a puzzle. One must draw reasonable inferences from the facts based on their timing and the surrounding circumstances." Thomas C. Newkirk, Assoc. Dir., Div. of Enforcement, & Melissa A. Robertson, Senior Counsel, Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Speech by SEC Staff: Insider Trading: A U.S. Perspective at the 16th International Symposium on Economic Crime, Jesus College, Cambridge, England (Sept. 19, 1998), http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm [hereinafter Speech by Newkirk & Robertson].

[21] *Id.* Concealment of insider trading easily occurs by those who "split their trades between equity and options markets, break their trades into small blocks, trade through off-shore accounts, and use multiple brokers to execute the trades . . . ." A.C. Pritchard, U.S. v. O'Hagan: *Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 52 (1998).

[22] *See* Speech by Newkirk & Robertson, *supra* note 20.

investigations often proceed under various violations of federal securities laws.[23]

Hedge fund involvement in insider trading is particularly difficult for the government to detect because hedge funds may be unregulated investment funds.[24] Hedge funds market themselves as high-risk, high-return investments and are under enormous pressure to show profits for their clients.[25] Thus, hedge funds are more likely to risk overstepping the law to obtain an edge in achieving sizeable financial returns. Despite the red flags increasingly raised by hedge fund activities,[26] this investment vehicle has escaped close government oversight.

Hedge funds invest across various financial markets, utilizing derivatives and sophisticated techniques, such as shorting stock and leveraging their investments;[27] investigations of hedge funds for insider trading thus must often cross financial markets.[28] It is now common to check financial market manipulation through the trading of options, warrants, or other derivatives.[29] High trading

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[23] SEC enforcement actions against hedge funds dropped from twenty-three cases in 2005 to thirteen cases in 2006. PRICEWATERHOUSECOOPERS, 2006 SECURITIES LITIGATION STUDY (2007), *available at* http://10b5.pwc.com/PDF/070918%20SEC%20LIT%20STUDY%202006_FINAL_66948_V2_CT.pdf.

[24] About 2,000 hedge fund advisers have voluntarily retained registration with the SEC. *See* Siobhan Hughes, *Politics & Economics: Fund Advisers Deregister*, WALL ST. J., July 9, 2007, at A4.

[25] UK's Financial Services Authority has warned that criminal gangs are becoming more involved in insider trading. *See* Edward Fennell, *Insiders Beware of Criminal Acts*, TIMES ONLINE, July 10, 2007, *available at* http://business.timesonline.co.uk/tol/ business/law/article2047422.ece.

[26] *See* Walter Hamilton and Thomas S. Mulligan, *Wall Street Charges Recall Heyday of Insider Trading*, LOS ANGELES TIMES, Mar. 2, 2007, at A-1. *See also* PEQUOT REPORT, *supra* note 9, at 2.

[27] *See* ORG. FOR ECON. COOPERATION & DEV., STEERING GROUP ON CORPORATE GOVERNANCE, THE IMPLICATION OF ALTERNATIVE INVESTMENT VEHICLES FOR CORPORATE GOVERNANCE: A SYNTHESIS OF RESEARCH ABOUT PRIVATE EQUITY FIRMS AND ACTIVIST HEDGE FUNDS (2007) at 17.

[28] *See generally* David M. Bovi, *Rule 10b-5 Liability for Front-Running: Adding a New Dimension to the Money Game*, 7 ST. THOMAS L. REV. 103 (1994). (explaining "cross-market front-running").

[29] Angela Kwan, Int. Org. of Sec. Comm'ns, *The IOSCO Principles: Objectives and Principles of Securities Regulation* (2002), at 39, *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf.

volume through automated computer trading programs has enabled hedge funds to disguise insider trading in various financial markets more easily.[30]

In 2006, Congress raised questions as to whether the SEC was reluctant to investigate insider trading by powerful hedge funds.[31] The SEC's failure to investigate may have contributed to the rampant growth of insider trading by hedge funds.[32] As a result, the SEC faced Congressional pressure to make the prevention and prosecution of insider trading an enforcement priority.[33] In 2007, the SEC responded to this pressure by purportedly elevating prevention and prosecution of insider trading as an enforcement priority.[34] The priority has even resulted in the SEC bringing charges against a

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[30] *See* PEQUOT REPORT, *supra* note 9, at 16.

[31] While insider trading cases increased substantially in early 2007, such cases still comprise only 10% of the SEC's workload. *See* Brooke Masters, *Number of Suspicious U.S. Deals Increases*, FIN. TIMES, May 10, 2007, at 26. Insider trading cases have historically comprised only 7–12% of the SEC's caseload. SEC. & EXCH. COMM., PERFORMANCE AND ACCOUNTABILITY REPORT, 2006, at 11 (Exhibit 1.2: Distribution of Cases Across Core Enforcement Areas), http://www.sec.gov/about/secpar/secpar2006.pdf. Previously, from the mid 1980s through the early 1990s, insider trading constituted 15 percent of the SEC cases. *See Private Litigation under the Federal Securities Laws, Hearing before the Subcomm. on Securities of the S Comm. on Banking, Housing, and Urban Affairs*, June 17, 1993, at 4, 59 (statement of William McLucas, Director of SEC, Division of Enforcement), *reprinted in Abandonment of the Private Right of Action for Aiding and Abetting Securities Fraud/Staff Report on Private Securities Litigation: Hearing Before the S. Subcomm. on Securities of Comm. on Banking, Housing, and Urban Affairs,* 103rd Cong. 75 (1994).

[32] *See, e.g.*, David Koenig, *SEC Files Insider Trading Suit Over TXU*, WASH. POST, Mar. 2, 2007, *available at* http://www.washingtonpost.com/wp-dyn /content/article/2007/03/02/AR2007030201107.html. *See also* Jesse Westbrook & Otis Bilodeau, *U.S. Insider Trading Bill Takes Aim at Hedge Funds*, INT'L HERALD TRIB., Nov. 24, 2006, at Finance-16.

[33] *See* Walt Bogdanich & Gretchen Morgenson, *S.E.C. Is Reported to Be Examining a Big Hedge Fund*, N.Y. TIMES, June 23, 2006, at A1.

34 William Hutchings, *Regulator Takes Insider Trading Fears to Congress*, FIN. NEWS ONLINE, Apr. 3, 2007, http://www.efinancialnews.com/us edition/index/content/2447496088 (quoting SEC Chairman Cox for proposition that insider trading by hedge funds was one of three new emerging risks).

firm's chief compliance officer for aiding and abetting the firm's failure to prevent misuse of nonpublic information by the firm.[35]

Insider trading transactions that cross international borders are especially challenging to detect.[36] This is a concern of increasing magnitude, given the popularity of setting up offshore subsidiaries in countries with low or no taxes, like the Cayman Islands. Detection of insider trading is particularly hard if traders are using a tax haven country with strong secrecy laws to shield the identity of the party actually making the trade.

In the early 1990s, concern first arose about widespread insider trading by members of a creditors committee.[37] When hedge funds are part of a creditors committee evaluating the bankruptcy of a corporation, they become constructive insiders for insider trading purposes. They legitimately receive confidential information from the bankrupted or financially distressed corporation, but that information is not provided for the hedge fund's use in trading the companies' debt or securities. Security regulators are concerned that some hedge funds have obtained inside information while serving on a creditors' committee of a distressed company and illegally profited from that information.[38]

This article analyzes how hedge funds are susceptible to insider trading, particularly when acquiring information from a creditors' committee. Part II of this article explains the emerging role of hedge funds as significant insider trading participants. Part III discusses the laws prohibiting insider trading in the United States as

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[35] *See SEC Fires Another Warning Shot Over Insider Trading Policies and Procedures*, SEC. LAWFLASH, May 6, 2008, at 1, *available at* www. morganlewis.com (describing an SEC enforcement action against an officer at a broker-dealer not for direct insider trading but for failing to adopt anti-insider trading procedures).

[36] *See* KPMG, CROSS-BORDER INVESTIGATION: EFFECTIVELY MEETING THE CHALLENGE (2007), *available at* http://www.kpmg.com/NR/rdonlyres/2424 5292-F563-443D-8583-091B253CF71/0/CrossBorderInvestigations.pdf. "The investigation of cross-border fraud and misconduct frequently involves numerous legal issues, jurisdictions, and cultural challenges." *Id.* at 6. *See generally* Michael D. Mann & William P. Barry, *Developments in the Internationalization of Securities Enforcement,* 39 INT'L LAW. 667, 689 (2005).

[37] Mark J. Krudys, *Insider Trading by Members of Creditor Committees:Actionable!*, 44 DEPAUL L. REV. 99, 101 (1994).

[38] *See* Emily Thornton, et al., *More Heat on Hedge Funds*, BUS. WK., Feb. 6, 2006, at 42.

applied to hedge funds and the international efforts to prevent inappropriate insider trading.[39] Part IV proposes industry-wide, legislative, and international solutions for minimizing insider trading problems emerging from hedge funds and restoring integrity to creditors committees.

II. Hedge Funds' Various Roles in Insider Trading Cases

Hedge funds comprise an important segment of the international financial markets. Part A identifies hedge fund characteristics conducive to insider trading, including the industry's substantial size, frantic trading activities, profit maximization motives, cozy relationships, tight secrecy, offshore domiciles, and aggressive business practices—characteristics that increase the difficulty of detecting and prosecuting insider trading. Part B discusses recent hedge fund securities fraud cases that illustrate hedge funds taking an increasing role in insider trading cases. Part C explains the ability of hedge funds to access inside information through positions on creditors' committees in cases of corporate bankruptcy.

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[39] The SEC has two major types of arrangements with foreign countries for information sharing and cooperation in investigation and prosecution: "Mutual Assistance Treaties in Criminal Matters" and "Memoranda of Understanding" (MOUs). Speech by Newkirk & Robertson, *supra* note 20, at 16–17. The MOUs enable the SEC to take an enforcement action even when the evidence is acquired abroad. Mann & Barry, *supra* note 36, at 670. The SEC has more than thirty cooperative arrangements with regulators in other countries. Speech by Newkirk & Robertson, *supra* note 20, at 16–17 ("The SEC has entered into 32 arrangements with foreign counterparts for information sharing and cooperation in the investigation and prosecution of securities law violations."). Similarly, the Public Company Accounting Oversight Board (PCAOB), which provides standards overseeing the audit of public companies, has started entering into international agreements. Press Release, Pub. Co. Acct. Oversight Bd., PCAOB Enters into Cooperative Arrangement With Australian Securities and Investments Commission, July 16, 2007, http:// pcaobus.org/News_and_Events/News /2007/07-16.aspx.

A. Hedge Fund Characteristics Conducive to Insider Trading

Hedge fund characteristics conducive to insider trading reveal cracks in the financial system that warrant industry, regulatory, and statutory attention. As members of a largely unregulated industry that takes big risks in hopes of earning big returns, hedge fund managers may be more susceptible to reckless behavior such as insider trading. Many reasons converge to make this choice even seem possible. First, the massive size of the industry encourages funds to get into even obscure areas of finance. In 2007, the global hedge fund industry was estimated to have accumulated as much as two trillion dollars in assets.[40] Because of hedge funds' substantial impact in various financial markets, hedge fund employees are often in a position to acquire material, nonpublic information that is useful for insider trading.[41]

Second, fast and high-volume trading is an important part of many funds' strategies. This means a lot of intra-day trading and aggressive, active trading strategies. Active trading by hedge funds results in their investment portfolios frequently changing.[42] Some hedge funds even employ split-second trading strategies in which a computer program decides when the hedge fund will buy or sell securities.[43] Frantic active trading by hedge funds makes it easier for them to camouflage trades based on insider trading.

Third, a motive to maximize financial returns, with little regard for risk, is common with both hedge funds and those involved

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[40] *See* Chiden Kurdas & Bill McIntosh, *HF Asset Levels Much Higher, Administrators Report*, HEDGEWORLD DAILY NEWS, July 20, 2007 (reporting that "around $1.9 to $2 trillion is the ballpark figure one most often hears" for global hedge fund assets).

[41] *See* Timothy W. Mungovan et al., *Insider Trading and Credit Derivatives*, *A New Take on an Old Crime*, FINANCIER WORLDWIDE, April 2007, *available at* http://www.nixonpeabody.com/linked_media/publications/insiderTrading _Mungovan-Sablone.pdf.

[42] Some hedge funds use computer models to determine automatically when to buy or sell companies. *See* Allister Heath & Helen Dunne, *Hedge Fund Headache: The Market Floor is Busy Pointing the Finger of Blame at Hedge Funds . . .* , THE BUS., Aug. 18, 2007.

[43] *See* Aaron Lucchetti, *Firms Seek Edge Through Speed As Computer Trading Expands*, WALL ST. J., Dec. 15, 2006, at A1.

in insider trading cases.[44] Hedge funds normally generate above-average financial returns by taking above-average risks, which has resulted in some devastating financial losses for investors.[45] They also have received public criticism for pushing the boundaries of securities laws intended to promote disclosure.[46]

Fourth, cozy relationships often exist between hedge funds and investment bankers who provide hedge funds with brokerage services.[47] This close relationship raises concern that some investment bankers could provide hedge funds with nonpublic information in order to continue to benefit from their lucrative trading commissions. High salaries and bonuses may cloud the judgment of those who service hedge funds. This concern makes it necessary for regulators to scrutinize hedge funds more closely for potential trading on inside information.[48]

Fifth, the tight secrecy that exists around hedge fund trading activities also shields insider trading activities. Hedge funds typically communicate very limited information about their investment strategies and financial results.[49] Tight secrecy creates an atmosphere in which hedge funds erroneously may believe their business activities are privileged and exempt from review for compliance with all securities laws.

Sixth, hedge funds, like other complex financial entities, are often organized such that one or many corporate subsidiaries of the

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[44] *See* Fin. SERV.'S AUTH., HEDGE FUNDS: A DISCUSSION OF RISK AND REGULATORY ENGAGEMENT, DISCUSSION PAPER 05/4 54 (2005) ("The very nature of hedge fund business means that they are vulnerable to involvement in market abuse, either advertently or inadvertently.").

[45] For example, in 2006, Amaranth lost about $6 billion in two weeks by misjudging the continued rise in natural gas prices. *See* Jenny Anderson, *Betting on the Weather and Taking an Ice-Cold Bath*, N.Y. TIMES, Sept. 29, 2006, at C1.

[46] *See* Carrick Mollenkamp, et al., *Breaking the Bank: For Hedge Funds, Hunting in Packs Pay Dividends*, WALL ST. J., Sept. 19, 2007, at A1.

[47] *See* HEDGE FUND WORKING GROUP, HEDGE FUND STANDARDS: PART I APPROACH TO BEST PRACTICE IN CONTEXT 37 (Oct. 9, 2007) .

[48] *See* Gretchen Morgenson, *Whispers of Mergers Set Off Bouts of Suspicious Trading,* N.Y. TIMES, Aug. 27, 2006, at A1 (reporting comments by a U.K. F.S.A. officer identifying hedge fund insider trading as a foremost concern).

[49] *See* SEC. & EXCH. COMM'N, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 46-47 (2003), *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf.

parent are domiciled offshore.[50] The Cayman Islands, for example levies no capital gains tax—making it an attractive home for an entity whose entire income would be subject to capital gains. Also, the Cayman Islands' strong bank secrecy laws help shield assets. Therefore, because of concern that not all the assets are apparent or accessible, a U.S. bankruptcy court may refuse to provide assistance to liquidation of hedge funds domiciled in the Cayman Islands.[51] Although the SEC has tried to collaborate with authorities offshore,[52] hedge funds' use of the Cayman Islands or another tax haven country lowers their risk that the SEC or other major securities regulators can acquire the real identity of certain traders and properly enforce insider trading laws.

Finally, the aggressive business practices of some hedge funds raise concerns. Allegations exist that some hedge funds manipulate the stock market prices of individual companies by colluding with securities analysts.[53] One tactic involves an analyst delaying widespread dissemination of a critical report of a company until a hedge fund has accumulated a substantial short position in that company.[54] This tactic causes the price of the target stock to decline and enables the hedge fund to profit illegally.[55] Another recent

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[50] *See id.* at 10.

[51] *See* Daniel M. Glosband, *Bankruptcy Court Rejects Cayman Proceedings of Bear Stearns Hedge Funds*, 26 AM. BANKR. INST. J. 38, 64 (Oct. 2007).

[52] *Offshore Tax Evasion: Hearing Before the S. Comm. on Finance*, 110th Cong. (2008) (statement of Michael Brostek, Dir., Strategic Issues, U.S. Gov. Accountability Office).

[53] *See Hedge Funds and Independent Analysts: How Independent are Their Relationships?: Hearing Before the S. Comm. on the Judiciary,* 109th Cong. (2006) [hereinafter *Independence Hearings*] (statement of Marc E. Kasowitz, Senior Partner, Kasowitz, Benson, Torres & Friedman LLP).

[54] *Id. Cf.* Christine Seib, *Hedge Fund Faces Lawsuit Over 'Dick Tracy' Allegations*, TIMES ONLINE, Aug. 19, 2006, http://business.timesonline.co.uk/tol/business/markets/united_states/article613582.ece (discussing allegations of a hedge fund employing a secret agent to blackmail employees of a company that the hedge fund was short selling).

[55] *See Independence Hearings*, *supra* note 53. Another technique that some hedge funds have used to manipulate stock values of individual companies is called "empty voting." Empty voting occurs when the voting rights are separated or emptied from the accompanying economic ownership. *See* Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 815 (2006). Paul S. Atkins, Comm'r, U.S. Sec. & Exchange Comm'n, Speech by SEC Commissioner: Remarks at the Corporate Directors Forum 2007 (Jan. 22,

concern is that some hedge funds may slant the valuation of securities that do not actively trade. The rationale for this practice is that the valuation distortion is needed to meet investors' expected performance goals for the hedge funds.[56]

B. Prominent Insider Trading Cases Involving Hedge Funds

Fraud requires an incentive, opportunity, and rationalization, factors that often arise in the hedge fund industry.[57] Although hedge funds are subject to the Securities Exchange Act's basic antifraud requirements,[58] the law has failed to prevent fraud in the over 300 actions by the SEC alleging insider trading.[59] In an industry largely reliant on self-regulation, the hedge fund cases may represent the tip of the iceberg of hedge fund violation of securities laws.[60] In the past few years, hedge funds were major participants in several notable fraud cases.[61] In September 2007, the SEC had more than thirty

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2007), *available at* http://www.sec.gov/news/speech/2007/spch012207psa.htm.

[56] *See* David Reilly & Gregory Zuckerman, *Pricing Tactics of Hedge Funds Put to Question: Some Managers Seem to Err on Sunny Side in Choosing Valuations*, WALL ST. J., Oct. 9, 2007, at C1.

[57] Greg N. Gregoriou & William Kelting, *The Billion-Dollar Hedge Fund Fraud*, 12 J. FIN. CRIME 172, 175 (2004) Greed is the usual incentive for hedge fund fraud, arising from the large potential compensation available to hedge fund managers. Opportunity to engage in fraud is heightened if the hedge fund manager possesses a strong concentration of power over funds. *Id.*

[58] *See* 15 U.S.C. § 78j (2000); 17 C.F.R. § 240.10b-5 (2007).

[59] *See Insider Trading Hearing, supra* note 14 (statement of Linda Chatman Thomsen).

[60] *See* Laurie P. Cohen & Kate Kelly, *Loose Leash—NYSE Turmoil Poses Question: Can Wall Street Regulate Itself?*, WALL ST. J., Dec. 31, 2003, at A1.

[61] *See* Kip Betz, *Hedge Funds: Hedge Fund Manager Charged in Alleged $ 88 Million Fraud Scheme*, Sec. L. Daily (BNA) (Feb. 2, 2007) ("Former hedge fund manager John. H. Wittier . . . was charged Feb. 1 with executing a securities fraud scheme that resulted in investor losses of approximately $ 88 million . . . ."); *Broker-Dealers: NASD Charges Two with Aiding Hedge Fund's Timing of Annuities*, Sec. L. Daily (BNA) (Feb. 16, 2007); Daisy Maxey, *Timing Case Puts Insurers in Spotlight*, WALL ST. J., Nov. 1, 2006, at A17 ("The National Association of Securities Dealers announced [in October 2006] that it fined hedge-fund manager Paul Saunders . . . $2.25

investigations into hedge fund manager misconduct pending in the northeastern United States.[62] Insider trading cases also may involve other violations of the law.[63]

Common legal violations include stock trading in advance of Private Investment in Private Equity (PIPE) transactions,[64] conflict of

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million for using deceptive practices to market time through variable annuities."); Sec. & Exch. Comm'n, SEC Settles Action Against Hedge Fund, HMC International, LLC, and Its Principals, Robert M. Massimi and Bret A. Grebow, Litig. Release No. 19,979 (Jan. 24, 2007) (alleging that a co-founder of a hedge fund materially misrepresented the hedge fund strategy, risk level, and financial performance), *available at* http://www.sec.gov/litigation/litreleases/2007 /lr19979.htm.

[62] *See* Dane Hamilton, *U.S. SEC Steps Up Probe of Hedge Fund Trading*, REUTERS, Sept. 27, 2007, http://www.reuters.com/article/companyNews AndPR/idUSN0336303620070804.

[63] Hedge funds can also help conceal insider trading by other parties. For example, in February 2007, the SEC and U.S. prosecutors alleged that the Rosenthal family had established a family hedge fund to hide their illegal trading of stock based on inside information. For several years, the Rosenthal father stole non-public information from his employer, an Israel-based pharmaceutical company. Furthermore, a Rosenthal son working for international accounting firm PricewaterhouseCoopers acquired nonpublic information about a pending merger and leaked that information to others. *See* Brooke Masters, *SEC Breaks Up Family-Run Insider Trading Ring Hedge Fund,* FIN. TIMES, Feb. 9, 2007, at 15; *see also* Sec. & Exch. Comm'n v. Aragon Capital Mgmt., No. 07 Civ. 919(FM), 2008 WL 216320, at *1 (S.D.N.Y. Jan. 16, 2008) (stating that members of the Rosenthal family pled guilty to conspiracy to commit securities fraud).

[64] "A PIPE ("Private Investment in Public Equity") is a private offering in which accredited investors agree to purchase restricted, unregistered securities of public companies. Only after the PIPE shares registration is approved by the SEC are investors free to sell them on the open market. A company can offer PIPE shares only to "'accredited' investors[, which are generally] investors with assets of $1 million or more." Press Release, Fin. Ind. Regulatory Auth., Hedge Fund Manager, Former Broker John F. Mangan, Jr. Barred, Fined $125,000 to Resolve Charges in PIPE Shares Deal (Dec. 20, 2005), *available at* http://www.finra.org/Newsroom/NewsReleases/2005/ P015760. The announcement of a PIPE generally lowers the price of the issuer's stock. *See* Peter O'Rourke, *PIPES—How to Avoid Regulatory Pitfalls* 15, http:// westlegalworks.com/presentations/imc2k6/ORourke.pps (last visited Nov. 29, 2008) ("Normally the announcement of a PIPE transaction has a detrimental effect on the price of an issuer's other publicly traded securities.").

interest, misappropriation of assets,[65] faulty information barriers within a trading firm, [66] and perjury.[67] Defendants have included prominent professionals, including the CEO of a hedge fund and distinguished third party service providers for hedge funds.[68]

The SEC has filed enforcement actions against hedge funds that profited from advance knowledge that a company was going to raise capital by issuing additional stock through a PIPE transaction.[69] In May 2005, in the CompuDyne case, the SEC alleged insider trading by Hilary Shane, the hedge fund manager of Millennium Partners.[70] Shane allegedly agreed to buy unregistered shares in a PIPE transaction[71] as part of a private placement in CompuDyne.[72]Betting that CompuDyne's stock price would drop, Shane allegedly engaged in prohibited short-selling of the

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[65] In a PIPE, a company sells unregistered stock at a discount because the stock is illiquid. The investor then hedges its PIPE purchase by shorting the public stock. Using the unregistered stock as a cover for the short sale is illegal. *See* Kara Scannell, *Three New York Hedge Funds Settle Charges Tied to Trading*, WALL ST. J., Mar. 15, 2006, at C4. The SEC wants to prevent broker-dealers from tipping hedge fund managers which leads the hedge fund to trade before any large transaction. *See* Richard Hill, *Division Staff Highlights Activities Involving Hedge Funds, Options Backdating*, Sec. L. Daily (BNA) (Feb. 14, 2007).

[66] *See* Barry W. Rashkover & Laurin Blumenthal Kleiman, *SEC Enforcement and Examination Concerning Hedge Funds*, 52 N.Y.L. SCH. L. REV. 599 (2007–2008).

[67] Besides various securities law violations, obstruction of justice and perjury charges sometimes arise. *See* L. HILTON FOSTER, INSIDER TRADING INVESTIGATIONS 16 (2000), http://ftp.sec.gov/about/offices/oia/oia_enforce/foster.pdf.

[68] *See* Kara Scannell, *Sentinel May Have Used Liquidity Crunch as Cover: SEC Charges company with Hiding Losses Over Several Months*, WALL ST. J., Aug. 21, 2007, at A3.

[69] *See* Bogdanich & Morgenson, *supra* note 33.

[70] Sec. & Exch. Comm'n, SEC Charges Hedge Fund Manager Hilary Shane with Insider Trading and Unregistered Sales of Securities in Connection with "PIPE" Offering, Litig. Release 19,227 (May 18, 2005), *available at* http://www.sec.gov/news/press/2005-76.htm.

[71] *Id.*

[72] CompuDyne's updated Business Ethics Policy applies to "all employees, directors, and those with whom CompuDyne has a subordinate contractual relationship including, but not limited to, subcontractors, vendors, sales representatives, consultants, and agents." SEC File 0-29789 (Apr. 5, 2006), *available at* www.secinfo.com/d13ACs.v37t.htm.

unregistered stock prior to the public announcement of the PIPE transaction.[73] Shane never admitted to wrongdoing, but settled personally with the SEC for a $1.45 million fine.[74] Under a resulting agreement with the SEC, Millennium Partners made several improvements in its internal control to protect against future abuses.[75]

A "widespread and brazen international scheme of serial insider trading" consisted of at least three separate schemes; the SEC referred to these as the "Merrill Lynch Scheme," the "*Business Week* Scheme," and the "Grand Jury Scheme."[76] In the Merrill Lynch Scheme, the tipster from Merrill Lynch was compensated with a percentage of profits made from insider trading. The *Business Week* Scheme involved stealing copies of *Business Week* magazine prior to its distribution. The goal was to assess key portions of the "Inside Wall Street" column, which often moved the price of stocks it mentioned.[77] The Grand Jury Scheme involved leaking information about grand jury proceedings concerning potential accounting fraud at a pharmaceutical company to enable others to trade on this inside corporate information.[78] These three schemes illustrate the extensive penetration of some insider trading schemes into the fabric of professional society.

In March 2007, in the Wall Street trading ring case, the SEC charged fourteen defendants with a complex, inter-locking insider trading scheme.[79] The SEC described the scheme as "one of the most

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[73] Thornton et al, *supra* note 38.

[74] *Id.*

75 Internal control improvements included creating positions for a new chief legal officer and chief compliance officer, retaining an independent consultant to review procedures and future compliance, and establishing an oversight committee to manage such issues. Press Release, Office of the Attorney General of the State of New York, Mutual Fund Timing Fraud Revealed at Millennium Partners: Hedge Fund, Founder and Top Executives Will Pay $180 Million in Restitution and Penalties (Dec. 1, 2005), *available at* http://www.oag.state.ny.us/media_center/2005/dec/dec01a_05.html.

76*See* Sec. & Exch. Comm., Complaint, *SEC v. Anticevic*, 05 Civ. 6991 (S.D.N.Y July 26, 2006), at 2-3, *available at* www.sec.gov/litigation/complaints/2006 comp19775.pdf.

[77] *Id.* at 3.

[78] *Id.*

[79] Sec. & Exch. Comm'n, Mitchel S. Guttenberg, et al., Litig. Release 20,022, Mar. 1, 2007, *available at* http://www.sec.gov/litigation/litreleases/2007/lr20022.htm. The insider trading scheme netted at least $15 million in

pervasive Wall Street insider trading rings since the days of Ivan Boesky . . ." in the late 1980s.[80] The defendants included hedge fund portfolio managers, attorneys, compliance officers, and Wall Street traders at large investment banking firms Morgan Stanley, USB, and Bear Stearns.[81] One prominent defendant, Mitchel Guttenberg, illegally provided hedge fund traders with advance warnings to stock upgrades and downgrades. These communications comprised a form of material nonpublic information.[82] One trader who received tips from Mr. Guttenberg was Eric Franklin.[83] Mr. Franklin illegally traded on this inside information in his personal account and for two hedge funds that he managed.[84] The Wall Street trading ring case showed that even high level securities professionals have become willing to jeopardize their careers in pursuit of potential lucrative profits from insider trading.[85]

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illegal profits for the individuals and their hedge funds. *Id. See* Randall Smith, et al, *A 'Brazen' Insider Scheme Revealed*, WALL ST. J., Mar. 2, 2007, at C1.

[80] Jenny Anderson & Michael de la Merced, *13 Accused Of Trading As Insiders*, N. Y. TIMES, Mar. 2, 2007 at C1. Ivan Boesky, now known as the inspiration for the character Gordon Gekko in the movie *Wall Street*, in the late 1980s paid the SEC $100 million in fines and restitution to settle insider trading charges. He also paid almost $70 million to settle civil claims. *See Settlements Are Approved in Suits Against Boesky*, WALL ST. J., Feb. 11, 1997, at A8.

[81] Brooke Masters, *Wall Street Employer Among 13 on Insider Trading Charges*, FIN. TIMES, Mar. 2, 2007, at 1.

[82] *See id.*

[83] Mr. Franklin also was connected to a related insider trading scheme arising from a lawyer who worked in the global compliance department of Morgan Stanley. *See* Sec. & Exch. Comm., *supra* note 79. The lawyer acquired material, nonpublic information concerning impending corporate acquisitions of Morgan Stanley clients. The lawyer then also tipped Eric Franklin, a hedge fund, and others. She and her attorney husband have pleaded guilty to securities fraud and conspiracy in the insider trading scheme. *See Insider Trading: Former Morgan Stanley Official, Husband Plead Guilty in Insider Suit*, Sec. L. Daily (BNA) (May 11, 2007).

[84] Mr. Franklin also tipped another hedge fund portfolio manager who also illegally traded on the information. *See* Sec. & Exch. Comm., *supra* note 79.

[85] *Id; see also* Press Release Linda Chatman Thomsen, Division of Enforcement, Statement Concerning SEC v. Guttenberg (Mar. 5, 2007), *available at* www.sec.gov/ news/speech/2007/spch030107lct.htm.

The 2007 collapse of the two Bear Stearns hedge funds,[86] preceding the collapse of the firm itself, underscored the riskiness of hedge fund activities. This hedge fund collapse coincided with problems emerging in the subprime mortgage market.[87] The collapse prompted the SEC to start an informal inquiry into how the hedge fund industry is valuing mortgage-related securities similar to those held by Bear Stearns.[88] The collapse of these major hedge funds highlights the need for more government access to hedge fund trading data and greater transparency in hedge fund financial information.[89]

An analogous situation occurred when Barclays Capital initially sat on the unsecured creditors committee of a textile firm, but Barclays Capital withdrew from the committee after one year. Barclays Capital then joined an unofficial committee of secured creditors. The unsecured creditors committee accused Barclays Capital of violating its fiduciary duties to the creditors and misappropriating inside information it received. The settlement with Barclays Capital prompted the SEC to investigate. The SEC filed a complaint against the parent organization Barclays Bank that in at least six cases, it had purchased bonds for Barclays' accounts while aware of material, nonpublic information from representation on creditor committees. That information was misappropriated because of the failure to disclose the trades to the creditor committees. On

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[86] Bear Stearns had intended to bail out two of its failing hedge funds by extending them two to three billion dollars in emergency loans. "The loans have two purposes: first to prevent the hedge fund creditors from seizing and selling assets; and second, to prevent the hedge funds failure from triggering a systemic breakdown of the world's financial system." Richard Freeman, *Bear Stearns Funds' Failure Opened the Door to Credit Crash,* EXECUTIVE INTELLIGENCE REVIEW, July 6, 2007, *available at* http://www.larouchepub .com/other/2007/3427mbs_cdo_crash.html.

[87] *See* Kate Kelly, et al., *Subprime Uncertainty Fans Out*, WALL ST. J. ONLINE, July 18, 2007, http://online.wsj.com/article/SB118470713201469384.html.

[88] *See* Julie Cresswell, *A Close View of Crisis at Bear Stearns Funds*, INT'L HERALD TRIB., June 29, 2007, at 15. *See also* Susan Pulliam, *Deals With Hedge Funds May Be Helping Merrill Delay Mortgage Losses*, WALL ST. J., Nov. 2, 2007, at A1.

[89] The collapsed Bear Stearns hedge funds resulted in a criminal investigation. *See* Paul Davies et al., *Prosecutors Begin a Probe of Bear Funds: Fallout Continues for Mortgage Vehicles That Lost $1.6 Billion*, WALL ST. J., Oct. 5, 2007, at C1.

May 30, 2007, Barclays Bank paid almost $11 million to settle the insider trading charges with the SEC.[90]

A few notable insider trading cases have occurred outside the United States. For example, GLG Partners, Europe's third largest hedge fund, and its owner were accused of insider trading.[91] French regulators fined four hedge funds a combined $8.4 million after an insider trading investigation into Vivendi Universal.[92] As the capital markets continue to become more global, the importance of detecting insider trading scandals involving parties from multiple countries significantly increases.[93]

The Wall Street trading ring case, the Bear Stearns collapse, the Barclays Bank, and other cases discussed demonstrate that insider trading is a serious problem that arises even among trusted, high level professionals. These cases bring attention to the need for greater government oversight to instill fundamental standards of professionalism in the industry.

C. Hedge Funds Betraying Responsibilities on a Creditors' Committee

Hedge funds are sometimes involved on formal creditors' committees.[94] A creditors' committee is typically comprised of a

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[90] *See* Michael P. Richman & Jonathan E. Aberman, *Creditors Committees Under the Microscope: Recent Developments Highlight Hazards of Self-Dealing*, 26 AM. BANKR. INST. J. 22 (Sept. 2007); David Wighton, *$10.9m Settles Insider Trading Case*, FIN. TIMES, May 31, 2007, at 24.

[91] Michael Thomas et al., *More on FSA Investigation of Insider Trading at EU Hedge Fund GLG Partners*, DAILY CAVEAT, Feb. 2, 2006, http://www.caveat.net/blog/2006/02/more-on-fsa-investigation-of-insider.html.

[92] *See* Elisa Martinuzzi & Jacqueline Simmons, *France Fines Investors for Trading Violation*, INT'L HERALD TRIB., June 22, 2007 at Finance 16.

[93] French regulatory authorities are investigating "insider trading by twenty-one senior executives and two large corporate shareholders [who] were reported to have made 'strange, massive, and simultaneous sales of shares in the parent company of Airbus, just before the plane maker announced a calamitous delay in its super-jumbo [jet]." *See Insider Dealing Scandal Threatens Airbus*, N.Z. HERALD, Oct. 4, 2007, http://www.nzherald.co.nz/aviation/news/article.cfm?c_id=556&objectid=10467832.

[94] *See* Paul M. Goldschmid, *More Phoenix Than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUM. BUS. L. REV. 191, 201-02 (2005).

bankrupt company's debt holders and sometimes trade creditors.[95] Its responsibilities include investigating the debtor's business operations and financial condition, forming a proposed bankruptcy plan for the company, and other relevant services in the interests of the creditors.[96]

Obtaining sufficient, reliable information about the debtor allows a creditors committee to make better decisions. For this reason, committee members have access to substantial quantities of inside information on a company.[97] This places hedge funds in fiduciary roles to protect the company's confidential nonpublic information.[98]

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[95] The bankruptcy court appoints a bankruptcy trustee who selects members of a "creditors committee" if a company declares bankruptcy under Chapter 11. 11 U.S.C. § 1102(a) (2000). Although the size and composition of a creditor committee can vary, it usually includes the seven largest unsecured creditors who are willing to serve on the committee. *See* 11 U.S.C. § 1102(b)(1). The selection of creditor committee members is usually based on a questionnaire sent to the twenty largest unsecured creditors.

[96] *See* Patrick J. Reilley & J. Kate Stickles, *A Primer on the Reconstitution of a Creditors' Committee under Section 1102(a)(4)*, 26 AM. BANKR. INST. J. 48 (June 2007). "A well functioning creditors' committee can contribute to building consensus around sound and fair solution to business problems . . . ." Daniel J. Bussel, *Coalition Building Through Bankruptcy Creditors' Committees,* 43 UCLA L. REV. 1547, 1550 (1995-1996). Another major duty of a creditor committee is "to provide access to information to creditors who hold similar claims and are not on the committee." 11 U.S.C. § 1102(b)(3). *See also* Reginald W. Jackson, *New Challenges for Members of Creditor Committee and Their Counsel*, ABIWORLD.COM, http://www.abiworld.org/AM/Template.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=41343 (last visited Nov. 22, 2008).

[97] *See* Stephen Taub, *Hedge Fund Bankruptcy Role Seen Probed*, CFO.COM, Nov. 29, 2005, http://www.cfo.com/article.cfm/5244187/c_2984364. Hedge funds sometimes convert their debt holdings into control of the company, assuming the company reemerges from bankruptcy protection. *See* Henny Sender, *A Company's Road to Restructuring May Teem With Hedge-Fund Potholes*, WALL ST. J., Mar. 30, 2006, at C1. These bonds often face demands from hedge fund owners that the issuing U.S. company immediately pay the debt. The hedge funds then extract either substantial fees from the company or higher interest rates in exchange for an extension of their default deadline. *See* Peter Lattman & Karen Richardson, *Hedge Funds Play Hardball with Firms Filing Late Financials*, WALL ST. J., Aug. 29, 2006, at A1.

[98] For example, in March 2006 a large movie rental chain held a private conference call with about 200 lenders, comprised mostly of hedge funds.

In recent years, an ad hoc committee of creditors for a distressed or bankrupt company has commonly included hedge funds, because of the funds' increasing investment in debt securities. Such a committee is often voluntarily formed once the financial distress of a public company is apparent to its major creditors. An ad hoc committee can speak with one voice to suggest a bankruptcy plan to the distressed company. However, the committee members generally remain free to pursue their own self-interests.[99] The freedom from apparent fiduciary obligations enables ad hoc committee members to engage in unrestricted trading, although they may have disclosure requirements. The lack of fiduciary duties for an ad hoc committee member is a major advantage for those seeking to dispose of their investments in a company. However, some circumstances exist in which a court will impose fiduciary obligations on ad hoc committee members.[100]

Some companies experience financial distress when they are either unable to pay their financial obligations or experience a short-term cash flow problem. The debt owed by these companies is commonly referred to as *distressed debt*. The amount of distressed debt has increased ten-fold during the past decade.[101] About one-quarter of all distressed debt in the United States is now owned by hedge funds.[102] Hedge fund investments in a company's complex capital structure often range the entire sector from senior secured

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These hedge funds heard confidential, inside information about Movie Gallery's poor financial condition. During the next two days, Movie Gallery's shares were heavily traded and its stock plummeted twenty-five-percent prompting an SEC investigation. *See* Jenny Anderson, *As Lenders, Hedge Funds Draw Insider Scrutiny*, N.Y. TIMES, Oct. 16, 2006, at A1. The Movie Gallery case forced the trade association for lenders to announce new guidelines for handling confidential, material non-public information. *See* Press Release, Int.'l Swaps and Derivatives Assoc., Financial Market Trade Associations Issue Guidance for Handling Material Nonpublic Information in the Credit Derivatives and Debt Securities Markets (Oct. 7, 2003), *available at* http://www.isda.org/press/jmpfstandardsfinalized100703.html.

[99] Eric B. Fisher & Andrew L. Buck, *Hedge Funds and the Changing Face of Corporate Bankruptcy Practice*, 25 AM. BANKR. INST. J. 24 (Dec. 2006/Jan. 2007).

[100] *See infra* note 105 and accompanying text.

[101] *See* Taub, *supra* note 97.

[102] *See* Matt Miller, *Is the End Near?*, DAILY DEAL, Feb. 26, 2007.

bonds to junior subordinated bonds.[103] Because of their willingness to take on risks, hedge funds own most of the distressed debt traded in the secondary market.[104]

Fiduciary duties attach to members of a creditors' committee while they serve as fiduciary representatives for all bondholders and creditors.[105] If a corporation is in financial distress, the "duties of care and loyalty that ordinarily run solely to or for the benefit of shareholders 'shift' to corporate creditors."[106] Although liability can arise from breach of fiduciary duties,[107] many public companies will

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103 Hedge funds' ownership structure of debt demonstrates the need for the SEC to scrutinize common practices in the bond market. The SEC recently became concerned about lax practices in the bond market. *See* Kara Scannell, *SEC Chief Wants to Boost Oversight of Muni Market*, WALL ST. J., July 18, 2007, at C7.

[104] *See Finance and Economics: The Vultures Take Wing; Investing in Distress*, ECONOMIST, Mar. 31, 2007, at 96.

[105] 11 U.S.C. § 1102 (2000). *See also* Kurt F. Gwynne, *Intra-Committee Conflicts, Multiple Creditors' Committees: Altering Committee Membership and Other Alternatives for Ensuring Adequate Representation Under Section 1102 of the Bankruptcy Code*, 14 AM. BANKR. INST. L. REV. 109, 111 (2006). Historically, "corporate insiders do not owe a fiduciary duty to the firm's bondholders, " because their relationship, unlike that between stockholders and directors, is created and limited by contract. The obligations are thus similarly limited. Anonymous, *Insider Trading in Junk Bonds*, 105 HARV. L. REV. 1720, 1732 n.76 (1991–1992); s*ee also* Simons v. Cogan, 542 A.2d 785, 786 (Del. Ch. 1987), *aff'd* 549 A.2d 300 (Del. 1988) (holding that directors and officers do not owe the corporation's bondholders any fiduciary duty). *But cf.* Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies,* 32 DEL. J. CORP. L. 1, 7 (2007) (courts often reason that fiduciary relationships recognized in one business context impose fiduciary duties in analogous contexts).

[106] *See* Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189, 1190 (2002–2003).

[107] *See* Frances E. Freund, *Lender Liability: A Survey of Common-Law Theories*, 42 VAND. L. REV. 855, 862–63 (1989). A fiduciary duty can arise from exercising excessive control over management's decision making. Examples include "control of stock, selection of management, involvement in daily operations or financial management, or the use of borrower's business" to achieve the lender's purpose. *Id.* at 866 Potential liability is expanded under a theory called "deepening insolvency" which allows recovery from the defrauded management and those aiding its wrongful conduct. Deepening insolvency involves parties who enable a problem to

take further precautions with a creditors' committee and condition any transmission of material non-public information upon executing a confidentiality agreement with each member of the committee.[108]

When hedge funds act as lenders, they assume fiduciary duties.[109] These duties are similar in scope to the duties that corporate officers and directors owe to a corporation.[110] These fiduciary duties

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continue to worsen by creating a false impression of solvency to unsuspecting investors and creditors. *See* Official Comm. of Unsecured Creditors v. Lafferty & Co., 267 F.3d 340, 350 (3d. Cir. 2001) *See also* TaeRa K. Franklin, *Deepening Insolvency: What It Is and Why It Should Prevail*, 2 N.Y.U. J.L. & BUS. 435 (2005–2006).

[108] *See* Dennis J. Connolly, *New Law May Change Committee Composition and Practice*, ABIWORLD.COM, at 4, http://www.abiworld.org/webinars/BusinessBankruptcyII/connolly.pdf (last visited Dec. 1, 2008). Debt securities or bonds often have covenants that restrict a company's actions. Thus, creditors often indirectly influence corporate policies. For example, creditors might impose restrictive covenants in restructuring loan agreements or compensating senior management. *See* Stuart C. Gilson & Michael R. Vetsuypens, *Creditor Control in Financially Distressed Firms: Empirical Evidence*, 72 WASH. U. L. Q. 1005, 1007 (1994) ("Even though creditors are generally constrained from taking a direct management role in these firms, this research shows that creditors are able to influence corporate policy indirectly by imposing highly restrictive covenants in restructured lending agreements, replacing senior management, and influencing the terms of senior executives' compensation."). One of every two major creditors has veto power over a company's dividends and stock repurchases. *See id.* at 1009. Between five and fifteen percent of major creditors have some veto power over a company's additional borrowing, capital expenditures, divestitures, the firm's annual operating budget, or mergers. *Id.*

[109] Creditor committee duties were increased in 2005 when the new bankruptcy law required creditor committees to disclose information to the constituencies that the committee represents. *See* 11 U.S.C. §§ 1102(b)(2)-(3). *See generally* Burke Gappmayer, *Protecting the Insolvent: How a Creditor's Committee Can Prevent Its Constituents from Misusing a Debtor's Nonpublic Information and Preserve Chapter 11 Reorganizations*, 2006 UTAH L. REV. 439 (2006).

[110] Agents of a bankrupt firm owe a fiduciary duty to creditors. *See generally* Ramesh K.S. Rao et al., *Fiduciary Duty a la* Lyonnais*: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, 22 J. CORP. L. 56 (1996–1997); Stacey K. Lee, *Piercing Offshore Asset Protection Trusts in the Cayman Islands: The Creditors' View*, 11 TRANSNAT'L LAW. 464, 506-16 (1998) (explaining generally the distinctions between types of bankruptcy fraud).

are often articulated as duties of care, loyalty, and good faith.[111] A creditor committee's use of material, non-public corporate information for personal gain violates the duty of loyalty.[112] The problem of hedge funds using inside information to trade in the stock market is reminiscent of the problem in the 1980s when insider trading occurred in junk bonds.[113] In both cases, inside information was misappropriated.

Hedge funds are increasingly involved in many corporate bankruptcy proceedings,[114] which necessitate the use of Chinese walls to keep information that was confidentially obtained in the creditors committee separate from the trading parts of the firm.[115] Thus, Chinese walls separate securities traders from the individuals acquiring inside information on creditor committees.[116] In 2000, the

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[111] *See* Carter G. Bishop, *A Good Faith Revival of Duty of Care Liability in Business Organization Law* (Suffolk University Law School Research Paper 07-02, 2007), *available at* http://ssrn.com/abstract=930402.

[112] *See* Dirks v. Sec. & Exch. Comm'n, 463 U.S. 646, 662 (1983) ("Absent some personal gain, there has been no breach of duty to stockholders"). *See generally* Latham & Watkins, *Fiduciary Duties and Potential Liabilities of Directors and Officers of Financially Distressed Corporations*, INT'L INSOLVENCY INST. (2000), *available at* http://www.abanet.org/buslaw/newsletter/0003/materials/tip3.pdf.

[113] *See* Taub, *supra* note 97 (reporting the SEC's inquiry whether hedge fund representatives secure positions on corporations' board of directors to gain and maintain access to insider information).

[114] *See* Fisher & Buck, *supra* note 99, at 86, 87 n.5.

[115] *Id.* ("In order to perform their function as fiduciaries, particularly investigation of the debtor's financial condition and participation in the formulation of a plan, members of official committees must necessarily have access to confidential information. Accordingly, entities sitting on official committees cannot trade when in the possession of such material, nonpublic information absent appropriate ethical screening measures isolating employees sitting on the committee from those with trading authority.") *See also* Edward Hayes, *SEC Hunting Insider Trading in Hedge Funds*, CCH WALL ST., Feb. 21, 2007, http://www1.cchwallstreet.com/ws-portal/content/ news/pdf/02-21-07.pdf (highlighting the uptick in suspicion of insider trading within many hedge funds and the need for effective Chinese walls).

[116] A Chinese wall is meant to separate different lines of business within the same firm. For example, a Chinese wall should segregate material, nonpublic information from traders. This separation enables traders to continue their trading activities without insider trading concerns. A Chinese wall is essentially required under the 1984 Act: "Prevention of misuse of

SEC effectively relaxed securities requirements for creditor committee members who wish to trade in the debtors' securities by giving explicit "approval of the use of ethical [Chinese] walls."[117] However, "some hedge funds maybe too small to erect an effective Chinese wall."[118]

The motives of hedge funds serving on creditor committees often differ from banks and other traditional creditors on a creditors committee. It is possible for a hedge funds or other large debt holder to force companies into bankruptcy because they hope to own the company after it emerges from bankruptcy. Thus, during a corporate bankruptcy, a hedge fund creditor sometimes seeks to exchange debt for an ownership interest in the company.[119] This tactic, known as

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material, nonpublic information. Every registered broker or dealer shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse in violation of [15 U.S.C. §§ 78a et seq.], or the rules or regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer." 15 U.S.C. § 78o(f) (2000). *Cf.* Shalini M. Aggarwal, *From the Individual to the Institutions: The SEC's Evolving Strategy for Regulating the Capital Markets*, 2003 COLUM. BUS. L. REV. 581, 599–602 (2003). In practice, however, many analysts have ignored their firm's Chinese wall and actively participated in the investment banking business. *See* Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1041 (2003) ("Many of these brokerage firms also have an investment banking division. In addition to doing research for customer reports, analysts who work for those firms also may perform research for the underwriting of an issuer's securities, participate in the road show (actually traveling to pitch securities), or help clinch the underwriting deal.").

[117] *See* Robert J. Benjamin, *Fiduciary Responsibilities of Creditor Committees with Respect to Securities and Commodities Transactions,* 10 AM. BANKR. INST. L. REV. 493, 498 (2002).

[118] Daniel Sullivan, *Big Boys and Chinese Walls*, 75 UNIV. CHI. L. REV. 533, 559 (2008).

[119] *See* Mark Berman & Jo Ann J. Brighton, *Hedge Funds: Lessons Learned from the Radnor Decision*, 26 AM. BANKR. INST. J. (Feb. 2007), at 30, 66-67.

"loan-to-own,"[120] injects more uncertainty into the bankruptcy restructuring process for the company.[121]

In 2005, the SEC accused the hedge fund manager of Blue River Capital LLC of using false trades to acquire a position on WorldCom's creditor committee.[122] In reality, the Blue River hedge fund had only a $6.5 million face value claim against WorldCom, rather than the $400 million of bonds Blue River portrayed itself as owning.[123] The hedge fund then used that creditor committee position to obtain nonpublic information from the bankrupt company to engage in insider trading on WorldCom and the two other companies, Adelphia and Globalstar. In essence, the hedge fund misrepresented its position to obtain access to the inside information and then wrongfully used the inside information.[124]

III. Insider Trading Laws as Applied to Hedge Funds on a Creditors Committee

The prohibition of insider trading in public companies arises primarily through judicial interpretations of federal securities laws prohibiting fraud.[125] Part A discusses insider trading laws in the

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[120] *Id.*; *see also In re* Radnor Holdings Corp., 353 B.R. 820 (Bankr. D. Del. 2006).

[121] *See* David Peress & Thomas C. Prinzhorn, *Value and Cents: Nontraditional Lenders and the Impact of Loan-to-Own Strategies on Restructuring Process,* 25AM. BANKR. INST. J. (Apr. 2006), at 48, 57.

[122] In the Matter of Van D. Greenfield and Blue River Capital, LLC, Exchange Act Release No. 52,744, 86 SEC Docket 1623 (Nov. 7, 2005). The SEC also noted that Blue River hedge fund failed to have effective Chinese walls or similar information barriers to prevent misuse of the inside information with a Chinese wall. *See id.* at 4.

[123] Blue River had entered into "a simultaneous backdated purchase and short sale of $400 million in face amount of WorldCom bonds to secure a position on the WorldCom committee." Michael P. Richardson & Jonathan E. Aberman, *Creditor Committee Under the Microscope: Recent Developments Highlight Hazards of Self-Dealing*, 26-7 AM. BANKR. INST. J., Sept. 2007, at 22, 62.

[124] The principal of Blue River settled charges with the SEC that he failed to guard against the potential misuse of inside information. *See* Otis Bilodeau, *SEC Probes Bankruptcy Committee for Hedge Fund Fraud*, BLOOMBERG.COM, Nov. 29, 2005, http://www.bloomberg.com/apps/news?pid=10000103&sid=a1yyTgCjH.qM&refer=us.

[125] State law precedent also may apply insider trading concepts to private companies. *See, e.g.*, Lawton v. Nyman, 327 F.3d 30, 39-40 (1st Cir. 2003)

United States from its statutory basis to the regulatory interpretations by the SEC. Part B takes on the applicability of insider trading rules to debt instruments. Part C discusses the courts' acceptance of the misappropriation theory of insider trading and considers this theory as applied to hedge funds serving on a creditors committee. Part D examines the SEC's reluctance to investigate insider trading related to prominent hedge funds. Part E provides an international insight, which is especially important because the new wave of insider trading by hedge funds often crosses national boundaries.

A. Insider Trading Laws from Statutory and Regulatory Sources

The legal theory underlying insider trading is constructive fraud.[126] U.S. securities statutes do not expressly prohibit insider trading, except for securities related to a tender offer.[127] Prosecutions and convictions for violations of insider trading laws are primarily the result of judicial interpretation of the securities laws on fraud.[128] Insider trading cases are difficult to prosecute by the SEC for civil action and even more so for criminal proceedings brought by the Department of Justice.[129]

(holding officers of closely held companies can have a heightened duty of disclosure under Rhode Island law). *See generally* WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING, ch. 15 (2d ed. 2006).

[126] Donald C. Langevoort, *Rereading* Cady, Roberts: *The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1321 (1999); *see* Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post- Restatement*, 70 CAL. L. REV. 1, 2 (1982).

[127] *See* Securities Exchange Act of 1934 § 16(a)-(b), 15 U.S.C. § 78p (2000) (stating officers, directors and shareholders owning ten percent or more must disclose all trades to the SEC and surrender all short-swing profits made by buying and selling within the short-term six-month window); 17 C.F.R. § 240.14e-3 (2007). *See generally* Laura Ryan, *Rule 14e-3's Disclose or Abstain Rule and Its Validity Under Section 14(e)*, 60 U. CIN. L. REV. 449, 453-54 (1991); Ellen Taylor, *Teaching an Old Law New Tricks: Rethinking Section 16*, 39 ARIZ. L. REV. 1315, 1333 (1992).

[128] *See* Speech by Newkirk & Robertson, *supra* note 20.

[129] The Department of Justice makes an independent decision for pursuing criminal prosecution of insider trading. SEC Enforcement Activities Rule, 17 C.F.R. § 202.5(f) (2007) (stating that the SEC can determine a securities violation except in matters involving criminal conduct, which is the province of the Department of Justice); *see, e.g.*, Dionne Searcey, *Qwest Ex-*

The fundamental U.S. securities laws were established in the 1930s, decades before the hedge fund industry existed. Noting that manipulation and dishonest practices thrive on secrecy, Congress enacted the Securities Exchange Act of 1934, governing the subsequent resale of stock.[130] Section 10(b) of this Act is the basis for most securities fraud litigation, including insider trading violations.[131] It prohibits any person from directly or indirectly[132] using "any manipulative or deceptive device or contrivance" "in connection with"[133] the purchase or sale of securities if it violates the SEC rules.[134] By providing the SEC with broad powers, Section 10(b) combats securities fraud and provides the basis for prohibiting insider trading.

The SEC's Rule 10b-5 builds on the "any manipulative or deceptive" conduct language of Section 10(b).[135] Rule 10b-5 concerns with three types of improper conduct:[136] using any device

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Chief Gets 6 Years In Prison for Insider Trading, WALL ST. J., July 28, 2007, at A3.

[130] *See* Basic Inc. v. Levinson, 485 U.S. 224, 230 (1988) ("'There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy.'" (quoting H.R. REP. NO. 73-1383, at 11 (1934))).

[131] *See generally* Steve Thel, *The Original Conception of Section 10(b) of the Securities Act*, 42 STAN. L. REV. 385 (1990) (discussing the different interpretations as to how the SEC can use Section 10(b) to determine insider trading violations).

[132] Indirect violation of Section 10(b) does not include aiding and abetting fraud. *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994) ("Because of our conclusion that there is no private aiding and abetting liability under § 10(b), Central Bank may not be held liable as an aider and abettor.").

[133] *See In re* Parmalat Sec. Litig., 376 F. Supp. 2d 472, 505-06 (S.D.N.Y. 2005) ("A plaintiff makes out a sufficient nexus with the purchase or sale of securities when the defendants' deceptive conduct affects a market for securities."). *See generally* Lewis D. Lowenfels & Alan R. Bromberg, *Rule 10b5's In Connection With Requirement: A Nexus for Securities Fraud*, 57 BUS. LAW. 1 (2002).

[134] Securities Exchange Act of 1934 §10(b), 15 U.S.C. § 78j(b) (2000).

[135] *See* Sec. & Exch. Comm'n v. Zandford, 535 U.S. 813, 816 n.1 (2002) (holding Rule 10b-5's scope is coextensive with Section 10(b)'s coverage). In 1942, the SEC hastily drafted Rule 10b-5. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 n.32 (1976).

[136] Rule 10b-5 mimics the language of Section 17(a) of the Securities Act of 1933 which addresses "fraudulent interstate commerce." *Cf.* Paul Horton,

or scheme to defraud;[137] making any untrue statement of material fact or omission; or engaging in a practice constituting fraud.[138] Liability under Rule 10b-5 must also satisfy the common law elements of fraud: scienter, [139] materiality, [140] reliance, [141] causation,[142] and damages.[143] Thus, the defendant must have used non-public information[144] to engage in fraudulent conduct or made an untrue

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Section 17(a) of the 1933 Act: The Wrong Place for a Private Right, 68 NW. U. L. REV. 44, 49 (1973).

[137] SEC Employment of Manipulative and Deceptive Devices Rule, 17 C.F.R. § 240.10b-5 (2007) ("It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud. . . .").

[138] *Id.*

[139] *Scienter* is a mental state consistent with the intent to deceive, manipulate, or defraud. *Ernst & Ernst*, 425 U.S. at 193–94 n.12. Proof of scienter for private securities fraud class actions requires providing the facts that give rise to a strong inference that the defendant acted with the required state of mind. *See* Private Securities Litigation Reform Act § 21D(b)(2), 15 U.S.C. §78u-4(b)(2) (2000); Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2509-10 (2007).

[140] *Materiality* is a substantial likelihood that a reasonable shareholder would consider the information important in the investment decision. *See* Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (applying materiality in the context of Section 10(b) and Rule 10b-5).

[141] *Reliance* is presumed to exist if a company's securities are traded in an efficient stock market because of the "fraud on the market" doctrine. *Id*. The need for reliance varies depending upon the securities provision at issue. Recognizing the unique difficulties in identifying evidence of insider trading, Congress adopted §20A of the 1934 Act in order "to provide greater deterrence, detection, and punishment of violations of insider trading." Lampf, Pleva, Lipkind, Prupis & Petrigrow v. Gilbertson, 501 U.S. 350, 361 (1991) (citing H.R. REP. NO. 100-910, at 7 (1988)).

[142] *Proximate result*, also known as "loss causation," requires a casual link between the misconduct and the damages sustained. Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 341-42 (2005). *See generally* James C. Spindler, *Why Shareholders Want Their CEOs To Lie More After Dura Pharmaceuticals*, 95 GEO. L.J. 653 (2007).

[143] *See Ernst & Ernst*, 425 U.S. at 197.

[144] A defense attorney might show that the information became public "due to rumors and leaks from the company or others." *See* Ron Heim, Meyers & Heim LLP, *How to Win an Insider Trading Case*, *available at* www.meyers andheim.com/insider_trading_pr.html (last visited Dec. 1, 2008).

statement or omission of material fact in the sale of securities.[145] The Supreme Court has explained that section "10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities . . . . Novel or atypical methods should not provide immunity from the securities laws."[146] New situations, such as hedge funds acting as fiduciaries on a bankrupt company's creditors committee, should not prevent the application of insider trading laws.

In 1984, in the Insider Trading Sanctions Act, Congress sought to prevent and punish insider trading.[147] A series of high profile insider trading cases in the early 1980s[148] led Congress to create a treble penalty for the profits from insider trading.[149] Congress also broadened the statutory definition of securities because the options market significantly affects the stock market.[150] However, at the urging of the SEC, Congress did not statutorily define the term "insider trading."[151]

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[145] The definition of *securities* includes options and related financial instruments. *See* Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (2000). In 1984, Congress broadened the statutory definition of securities because the options market significantly affects the stock market. *See* Elizabeth M. Sacksteder, *Securities Regulation for a Changing Market: Option Trader Standing Under Rule 10b-5*, 97 YALE L. J. 623, 632 (1987–1988) (finding that the options market allows investors to transfer risk from shareholders to option holders, making the stock market attractive to more investors and thus enhancing the depth and liquidity of the stock market); *see generally* Daniel C. Goelzer & Barrie L. Brejcha, *Inside Information: Prevention of Abuse*, *in* 15-3d CORP. PRAC. SERIES (BNA), at "Part II: Nonpublic Information" (stating that information may be considered public or nonpublic based on whether the people trading on the information caused the information to be fully impounded into the price of the particular stock).

[146] Superintendent of Ins. v. Bankers Life & Cas. Co., 409 U.S. 6, n.7 (1971).

[147] Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984).

[148] *See generally* U.S. GEN. ACCOUNTING OFFICE, SECURITIES REGULATION: EFFORTS TO DETECT, INVESTIGATE AND DETER INSIDER TRADING (1988).

[149] Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984). This 1984 Act also provided whenever insider trading of stock would violate the 1934 Exchange Act, insider trading of an option would result in comparable liability. Securities Exchange Act of 1934 § 20(d), 15 U.S.C. § 78t.

[150] *See* Sacksteder, *supra* note 145, at 632.

[151] *See* Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After* United States v. O'Hagan, 84 VA. L. REV. 153, 201 n.198 (1988).

In 1988, in the Insider Trading and Securities Enforcement Act, Congress broadened the application of the treble penalty for insider trading to any entity or person with direct or indirect control over the person committing the insider trading.[152] Also, Congress required registered brokers, dealers, and advisers to maintain policies to prevent insider trading by their employees.[153] Whistle-blowing on insider trading was mildly encouraged after Congress strengthened the potential bounties to those who provide information leading to penalties on insider trading.[154] The 1988 legislation also sought to internationalize securities investigations reflecting the emerging globalization of the financial markets.[155] Congress did not consider the unique problems with hedge funds because it was still a very small industry at the time.

Congress enacted securities reform in the Private Securities Litigation Reform Act of 1995,[156] with the dual goals of curbing "frivolous, lawyer—driven legislation, while preserving the investors' ability to recover on meritorious claims."[157] Although the

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152The Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"), Pub. L. .No. 100-704, 102 Stat. 4677, *modifying* Exchange Act of 1934 § 21A(1)(B), 15 U.S.C. § 78u-1(a)(1)(B). An employer may be considered a controlling person. A controlling person must know or recklessly disregard the fact that the violating person is likely to engage in the violation. *Id.*

[153] Securities Exchange Act of 1934 § 15(f), 15 U.S.C. §§ 78o(f), 80b-4(a).

[154] James Fisher, *Privatizing Regulations: Whistle-blowing and Bounty Hunting in the Financial Services Industries*, 19 DICK. J. INT'L L. 117, 135-36 (2000) (concluding that the lack of success for the SEC's bounty program was due to its weakness).

[155] The 1988 legislation empowered the SEC to investigate upon the request of foreign securities markets, regardless whether the facts suggest a violation of U.S. securities law. ITSFEA § 6(b)(2) (amending Exchange Act of 1934 § 21(a)(2)), 15 U.S.C. § 78(c)(a). The 1988 legislation intended to encourage other governments to provide reciprocal treatment of U.S. investigations abroad. International cooperation was further enhanced by the International Securities Enforcement Cooperation Act of 1990, especially section 24. *See* Mann & Barry, *supra* note 36, at 672.

[156] Private Securities Litigation Reform Act ("PSLRA*"),* Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered Sections of Title 15 and 18 in the U.S. Code) (establishing how court should handling private securities litigation). PSLRA was primarily an effort to prevent unjustified lawsuits against external auditors.

[157] Tellabs Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2509 (2007).

PSLRA restored the SEC's ability to bring action against aiders and abettors of securities fraud,[158] the Supreme Court has subsequently declined to find a private right of action in the statute.[159] With the Court's decision in effect, only the SEC was authorized to sue aiders and abettors of securities fraud. The 1995 law also reduced the legal risks for gatekeepers accused of insider trading primarily by substituting proportional liability for joint and several liability.[160]

As more financial fraud began to appear in the late 1990's, Congress nudged the SEC to take more regulatory action and preserve the United States' leading role as a safe-haven for investors.[161] Congress gave the SEC explicit authority to create rules that "prohibit fraud, manipulation, or insider trading."[162] In 2000, the SEC finally responded and defined "insider trading" when it enacted Rule 10b-5-1.[163] The rule established the rebuttable presumption that a person who purchases or sells securities is aware of any inside information in his or her possession. Thus, Rule 10b-5-1 provides an affirmative defense to an individual charged with insider trading if the individual entered into a trading plan before acquiring material non-public information.[164] Many corporate executives have now established "10b-5-1 trading plans" to protect them from potential

[158] Securities Exchange Act of 1934 § 20(e), 15 U.S.C. § 78t (2000). *See, e.g.*, *In re* Citigroup, Inc., Exchange Act Release No. 48,230, 80 SEC Docket 2116 (July 28, 2003), *available at* http://sec.gov/litigation/admin/34-48230.htm (ordering a cease and desist against Citigroup for a Section 10(b) violation and ordering Citigroup to pay certain monetary penalties for their involvement in Enron).

[159] Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, 511 U.S. 164, 167 (1994).

[160] PSLRA also raised pleading standards for securities class action and restricted application of criminal conspiracy law. *See* PSLRA, Pub. *L.* No. 104-67, § 101(b) (creating Securities Exchange Act of 1934 § 21D, 15 U.S.C. § 78u-4).

[161] *See generally* Joseph F. Morrissey, *Catching the Culprits: Is Sarbanes - Oxley Enough,* 2003 COLUM. BUS. L. REV. 801 (discussing the various ways Congress has expanded the SEC's powers over the last 15 years).

[162] Securities Exchange Act of 1934 § 10, 15 U.S.C. § 78j (2000).

[163] 17 C.F.R. § 240.10b5-1; Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act release No. 43,154, 65 Fed. Reg. 51,716 (Aug. 21, 2000).

[164] Allan Horwich, *The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1*, 62 BUS. LAW. 913, 922-23 (2007).

insider trading liability.[165] The SEC also established Rule 10b-5-2 on insider trading, as explained in a later section discussing the misappropriation theory.[166]

In 2002, after high profile corporate fraud at WorldCom and Enron, Congress enacted the Sarbanes-Oxley Act ("SOX").[167] SOX set a tone for a tougher enforcement environment at the SEC[168] and strengthened the global enforcement environment for securities laws.[169] Among the many changes under SOX, penalties were established for financial fraud,[170] white collar crime,[171] and improper certification of financial statements.[172] However, SOX did not

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165 *See* Alan D. Jagolinzer, *Do Insiders Trade Strategically Within the SEC Rule 10b5-1 Safe Harbor* 6 (2008), MGMT. SCI. (forthcoming) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=541502; Porter Wright Morry & Arthur, *Safe Harbor Rule 10b5-1 Trading Plans for Executives May Not Be "Safe" Anymore*, Mar. 2007, http://www.porterwright.com/publications/documents/610_SECSafeHarborRule10b5-1.Mar07.pdf. As a minimum precaution, one should memorialize the 10b5-1 trading plan instructions in writing and notarize the date of the instructions. CONSTANCE E. BAGLEY, WINNING LEGALLY: HOW TO USE THE LAW TO CREATE VALUE, MARSHAL RESOURCES, AND MINIMIZE RISK 69 (2005).

166 17 C.F.R. § 240.10b5-2 (2007). *See also infra* Part III.C.

167 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of Titles 11, 15, 18, 28, and 29 of the U.S. Code).

168 "Tough enforcement is essential for a strong securities market since it ensures that wrongdoers are punished and relinquish any benefits obtained by violations." COMM. ON CAPITAL MARKETS REGULATION, INTERIM REP., Nov. 30, 2006, at 72, http://www.capmktsreg.org/research.html.

169 Mann & Barry, *supra* note 36, at 669.

170 Sarbanes-Oxley Act §§ 801–807 (codified as amended in scattered sections of 18 U.S.C.A. §§ 1501–1520 (2006)). Most importantly, SOX established a new securities fraud statute, which can punish violators with a significant fine and/or a maximum 25 years in prison. Sarbanes-Oxley Act § 807, 18 U.S.C.A. § 1348. This provision gives "the Department of Justice the authority to prosecute securities fraud involving corrupt analysts and those including hedge funds that work with them." *Independence Hearinsg*, *supra* note 53 (statement of Marc E. Kasowitz).

171 Sarbanes-Oxley Act §§ 901-906 (codified as amended in scattered sections of 18 U.S.C.A. §§ 1341-1350).

172 *Id.* § 906 (codified at 18 U.S.C. § 1350 (2006)) A criminal penalty applies if the corporate executive knowingly and materially certifies reports misrepresenting financial information. Normally, the maximum penalties are a $1 million fine and ten years in prison. However, a corporate executive who willfully certifies reports misrepresenting financial information has a

address the unregulated environment for hedge funds and their activities on a creditors committee.

B. When Debt Qualifies as Securities under Section 10b-5

The federal securities laws only regulate securities. Thus, the prohibition against insider trading of securities under Section 10b-5 includes only debt types that qualify as a security. This author believes any type of securitized debt or debt tied with insurance should qualify as a security because the definition of a security includes almost any financial instrument sold as an investment,[173] but not short-term debt such as accounts payable. Thus, if debt is restructured, securities law should cover it.

The issue of debt qualifying as securities under Section 10b-5 was first raised in 1990 in *Reves v. Ernst & Young*.[174] The Supreme Court in this case established a modified "family resemblance" test to determine when notes qualify as securities under the securities laws. This test provided four factors for the courts to consider: the motivations of the buyer and seller; the plan of distribution of a note; the reasonable expectations of the investing public; and whether the risk of the instrument was reduced.[175] A note secured by a mortgage on a home generally did not qualify as a security under this test because it appeared on an enumerated list of notes that the Court recognized as non-securities.[176] Practically, the test created by the Court created a rebuttable presumption that a security exists.[177]

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maximum fine of $5 million and twenty years in prison. *See id.* § 906(c) (codified at 18 U.S.C. § 1350(c)).

[173] *See* Reves v. Ernst & Young, 494 U.S. 56, 61 (1990) ("Congress . . . enacted a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment.").

[174] *See id.* at 59-60.

[175] *Id.* at 66–67.

[176] *See* Cori R. Harper, *Sometimes Promising is Not So Promising: The Breakdown of the Family Resemblance Test*, 29 U. DAYTON L. REV. 71, 93 (2003–2004).

[177] In the ten cases following *Reves*, four courts held securities existed, five courts found no securities existed, and one left it to the jury. John C. Cody, *The Dysfunctional "Family Resemblance" Test: After* Reves v. Ernst & Young, *When Are Mortgage Notes "Securities"?*, 42 BUFF. L. REV. 761, 804 (1994).

The issue of which debt qualifies as securities has become more complex and important in the following two decades because Wall Street has created various types of debt and financial instruments. Two of the most popular variations are "credit default swaps" and "collateralized loan obligations" (CLOs).[178] The former "are a method by which a bank or an investor who buys a syndicated loan or bond may reduce default-risk exposure by buying credit insurance for the debt."[179] CLOs often arise when a bank sells a portfolio of commercial loans to a "special purpose vehicle" which then issues CLO securities to the capital markets, usually consisting of several classes, or tranches, of debt. The tranches are designed so that the 'safest' class of debt bears the lowest interest rate and the highest credit rating. As the debt securities are grouped into riskier classes with lower credit ratings, the interest rate increases.[180] Because CLOs often include contractual restrictions with the purchasers if the underlying loan goes bad, the CLOs are often ultimately acquired by distressed debt investors, [181] such as hedge funds.[182]

Although the court in *In re Worlds of Wonder Securities Litigation*[183] "acknowledged that liability under Rule 10b-5 required plaintiffs to allege a 'relationship of trust and confidence with corporate insiders,' it found that convertible debenture holders, like shareholders, have a relationship of trust and confidence with insiders of the corporation in whose performance they invest."[184] The court in recognized "that certain financial instruments, while technically denominated as 'debt,' nevertheless sufficiently resemble equity that similar duties to disclose under Rule 10b-5 must be recognized."[185]

Circuit courts of appeal have reached different conclusions in analyzing whether discretionary commodities futures contracts are

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[178] Goldschmid, *supra* note 94, at 231–33.
[179] *Id.* at 230.
[180] *Id.* at 233–34.
[181] *Id.* at 235.
[182] Critics of distressed debt investors essentially argue that these investors often provide mere window dressing in restructuring a distressed business, so they may sacrifice the long-term viability of the debtor in order to acquire a substantial and quick return on their investment. *Id.* at 265–67.
[183] No. C 87 5491, 1990 U.S. Dist. LEXIS 18396 (N.D. Cal. Oct. 19, 1990).
[184] Pengra, *supra* note 161, at 1381 (quoting *In re Worlds of Wonder*, *Id*. at *13).
[185] *Id.* at 1381–82.

subject to the securities laws.[186] Thus, "the distinction between puts, calls, futures, and options (securities) and commodities (not securities) remains an uncertain area of case law."[187] Because of the uncertainty in the courts, prosecutions concerning insider trading of securities would be helped by clarification. Congress should clarify the law by defining that any structured financial transaction, even one involving debt, creates a security and reporting obligations under the securities laws.

C. The Misappropriation Theory to Establish Fiduciaries as Insiders

Those outside of a corporation who are constructive insiders, tippees, or misappropriators are more often involved in insider trading than are traditional insiders.[188] Trading prohibitions apply all of these types of insiders. Constructive insiders acquire the fiduciary duties of true insiders, provided the corporation expected them to keep the information confidential.[189] *Tippees* are persons who receive important information from corporate insiders.[190] Tippees have potential liability if they knew or should have known that disclosure

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[186] Zathrina Perez, Eric Cochran, and Christopher Sousa, *Securities Fraud*, 45 AM. CRIM. L. REV. 923, 941-42 (2008).
[187] *Id.* at 942.
[188] "*Traditional insiders*" are "officers and directors of corporations, who in the regular course of their duties have access to material, nonpublic information." Terry Fleming, *Telling the Truth Slant: Defending Insider Trading Claims Against Legal and Financial Professionals*, 28 WM. MITCHELL L. REV. 1421, 1422 (2002).
[189] Dirks v. Sec. & Exch. Comm'n, 463 U.S. 646, 655 n.14 (1983). Dirks was a securities analyst who received an unsolicited tip from a former officer of a company was engaging in financial fraud. Dirks advised his clients about the alleged fraud. The SEC censured Dirks for passing along non-public inside information. The Supreme Court reversed and held that Dirks did not violate SEC's Rule 10b-5. *Id.* at 665.
[190] Speech by Newkirk & Robertson, *supra* note 20. Tippees are often friends and relatives who receive tips about important nonpublic information inside a company, such as impending acquisitions. Tippees who trade in the securities after receiving such non-public information are liable for insider trading. *See Dirks*, 463 U.S. at 656 ("Tippees such as Dirks who receive non-public, material information from insiders become 'subject to the same duty as [the] insiders.'").The Supreme Court noted that a personal benefit for a tippor can include not only any monetary gain, but also a reputational benefit that can create future earnings. *Id.* at 663.

of the information to a tippee had breached a fiduciary duty.[191] *Misappropriators* are those illegally misappropriating inside information.[192]

The traditional theory of insider trading is based on prohibiting a person who owes a fiduciary duty to either a corporation or its shareholders from trading in the company's securities while in possession of material nonpublic information on the company. Given that public disclosure of the confidential information would violate the insider's fiduciary duty of loyalty to the company,[193] the insider must refrain from trading. The traditional theory did not anticipate complex changes in the structure of business transactions during the last half-century and the ease with which parties could use third parties to create new forms of insider trading. The traditional theory is insufficient for prosecuting insider trading conducted by hedge funds, even though they arguably have a fiduciary duty not to trade on inside information while serving on a creditors committee.

The "misappropriation theory"[194] is an alternative to the traditional theory in determining who is considered an insider under

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[191] BAGLEY, *supra* note 165, at 68.

[192] Misappropriators may include "employees of law, banking, brokerage and printing firms who were given such information in order to provide services to the corporation whose securities they traded; government employees who learned of such information because of their employment by the government; and other persons who misappropriated, and took advantage of, confidential information . . . ." Sec. & Exch. Comm'n, *Insider Trading: Information on Bounties*, Jan. 6, 2006, http://www.sec.gov/divisions/enforce/insider.htm (last visited Dec. 1, 2008).

[193] The basic fiduciary duties include the duty of care, as well as with the duty of loyalty which encompasses the duty of good faith. *See generally* J. Travis Laster and Steven M. Haas, *Delaware Supreme Court Adopts the Caremark Standard While Holding Good Faith is Not an Independent Fiduciary Duty*, *in* INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR (Aspen Publishers 2006). The duty of loyalty requires acting on behalf of the entity and shareholders while refraining from self-dealing or using the opportunity for an improper personal benefit. *See* Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("The [duty of loyalty] requires an undivided and unselfish loyalty to the corporation [and] demands that there shall be no conflict between duty and self-interest.").

[194] The misappropriation theory was presented by the government in the first insider trading case to reach the Supreme Court. *See* Chiarella v. United States, 445 U.S. 222, 237 (1980). In *Chiarella*, an employee of a financial printer saw nonpublic information regarding a proposed merger from

insider trading law. The theory is important because it establishes when an outside person not having a duty to the corporation is liable for insider trading. The misappropriation theory essentially applies to outsiders who have either a fiduciary duty or similar duty of confidentiality.

Securities fraud exists under the misappropriation theory if the "trade in securities [occurs] in breach of fiduciary duty by secretly converting for personal use[ ] [material nonpublic] information which has been entrusted to him."[195] The misappropriation theory is a fraud perpetrated upon the person who was the source of the information,[196] rather than the traditional theory's failure to disclose information to the public. Because hedge funds have no obligation to disclose information they receive to the public, insider trades are not prosecuted on a "breach of fiduciary duty theory." Rather, misappropriation theory, converting inside information for personal use, fits the pattern of hedge fund insider trades.

Under the misappropriation theory of insider trading, "a person commits fraud in connection with a securities transaction when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the

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documents that he was hired to print. The printer then bought stock in the target company. *Id.* at 224. Lower courts criminally convicted the printer's employee of fraud. In a split decision, the Supreme Court reversed. The Court noted that "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)." *Id.* at 232. Chief Justice Burger's dissent in *Chiarella* suggested the misappropriation theory could apply. *Id.* at 240 (Burger, C.J., dissenting) ("I would read § 10(b) and Rule 10b-5 to encompass and build on this principle: to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."). Justice Stephens' concurring opinion suggested the possibility of a 10b-5 violation by misappropriating nonpublic information from the employer. *Id.* at 237–38 (Stevens, J., concurring). After the *Chiarella* decision, the SEC promulgated Rule 14e-3, 17 C.F.R. § 240.14e-3, *Transaction in Securities on the Basis of Material Nonpublic Information in the Context of Tender Offers*.

[195] DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT AND PREVENTION 6-1 (1992), *quoted in* Thomas A. McGrath III, *The Rise and Fall (and Rise?) of Information-Based Insider Trading Enforcement*, 61 FORDHAM L. REV. 127, 140 (1993).

[196] McGrath, *supra* note 195, at 141.

information."[197] In effect, the theory prohibits "an informational advantage from being obtained, not by superior experience, foresight or industry, but by some unlawful means."[198] The duty issue in misappropriation cases turns on whether the misappropriator obtained access to confidential information by exploiting the information source's reasonable expectation that information would be kept in confidence. Such reliance is justifiable in relationships that are "inherently fiduciary."[199]

In 1997, the U.S. Supreme Court upheld the misappropriation theory of insider trading in *United States v. O'Hagan*.[200] In that case, in July 1988, prominent Minnesota law firm Dorsey & Whitney was retained as local counsel for a proposed tender offer to buy Pillsbury, a company whose headquarters was in Minnesota.[201] James O'Hagan, a senior partner at Dorsey & Whitney, used the confidential information and purchased stock options in Pillsbury before the tender offer was announced in October 1988.[202] Consequently, O'Hagan faced criminal charges for insider trading.

After *O'Hagan,* courts have struggled to determine the boundaries of the misappropriation theory and the type of activity that will result in liability for securities fraud under Section 10(b).

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[197] United States v. O'Hagan, 521 U.S. 642, 652 (1997).

198 Joseph J. Humke, *The Misappropriation Theory of Insider Trading Outside the Lines of Section 10(b)*, 80 MARQ. L. REV. 819, 820 (1996–1997).

[199] United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991), *cert. denied* 503 U.S. 1004 (1992). *See* Randall W. Quinn, *The Misappropriation Theory of Insider Trading in the Supreme Court, A (Brief) Response to the (Many) Critics of* United States v. O'Hagan, 8 FORDHAM J. CORP. & FIN. L. 865 (2003). To establish reliance, before 2000 some courts required proof of actual use of the information. Other courts were more lenient and merely required proof of possession of the inside information. A rebuttable inference often exists in the civil cases when one is in possession of material nonpublic information; in contrast, in the criminal context, reliance has the stricter requirement of actual use of the material nonpublic information.

[200] 521 U.S. at 651–52 (holding that criminal liability may be predicated on the misappropriation theory). Previously, the Court had been split on the legality of the misappropriation theory. *See* Carpenter v. U.S., 484 U.S. 19, 24 (1987).

[201] United States v. O'Hagan, 92 F.3d 612, 614 (1996).

[202] *O'Hagan*, 521 U.S. at 647–48. (explaining that by the end of September 1988, O'Hagan had amassed 2,500 Pillsbury call option contracts and held approximately 5,000 shares of Pillsbury common stock which he had purchased on September 10, 1988).

The important inquiry is whether "the informational advantage [was] improperly obtained, that is, one which others cannot obtain through lawful means or competition."[203] The misappropriation theory is consistent with the purpose of the federal securities laws to ensure honest securities markets and promote investor confidence.[204] Misappropriation has evolved into the SEC's preeminent prosecutorial weapon for combating fraudulent securities trading practices, such as insider trading.

In 2000, the SEC adopted Rule 10b-5-2 to address when a breach of duty creates liability under the misappropriation theory of insider trading.[205] Rule 10b-5-2 provides three alternatives for determining when a person receiving material nonpublic information is probably subject to a "duty of trust or confidence" for purposes of the misappropriation theory. These three alternatives are (1) the recipient agreed to maintain the information in confidence; (2) the person communicating the material nonpublic information[206] and the recipient has a history that created a reasonable expectation of confidentiality; or (3) the person who provided the information was a close relative of the person receiving it. Rule 10b-5-2 created a clearer standard that enables the government to apply insider trading laws more consistently.

Regulatory solutions, however, are not sufficient. Congress should codify the misappropriation theory, rather than just rely upon the courts to uphold this essential doctrine needed for proper enforcement of securities fraud.

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[203] *See* Robert B. Titus and Peter G. Carroll, *Netting the Outsider: The Need for a Broader Restatement of Insider Trading Doctrine*, 8 W. NEW ENG. L. REV. 127, 151 (1986).

[204] Selective Disclosure and Insider Trading, Securities Act Release No. 7881, *supra* note 5, at 20 ("The rules are designed to promote the full and fair disclosure of information by issuers, and to clarify and enhance existing prohibitions against insider trading.").

[205] *Id.*

[206] Whether information was public was the issue in the "squawk box case," an insider trading case. The investment firm announced client purchases over a squawk box. *See* Chad Bray, '*Squawk Box' Trial to Hear Leak Claims*, WALL ST. J., Mar. 19, 2007, at C3.

D. SEC Investigations Stymied by Hedge Funds with Connections

The SEC's firing of staff lawyer Gary Aguirre[207] arose from Aguirre's efforts to investigate insider trading violations by the large, prominent hedge fund Pequot Capital Management.[208] Aguirre's investigatory efforts were thwarted by SEC management after he focused attention on Morgan Stanley's current Chief Executive Officer John Mack.[209] The SEC fired Gary Aguirre after he claimed that that the SEC was reluctant to investigate influential figures.[210] The firing occurred despite positive performance reviews of Aguirre and a merit pay raise during his short tenure with the SEC.[211]

A subsequent Congressional Report investigating the issue concluded that the information obtained by Aguirre was "promising."[212] The Congressional Report found "highly suspicious" trades by the hedge fund.[213] It also found that "[t]he SEC examined only a fraction of the other suspicious Pequot trading highlighted by [the NYSE and NASD]."[214] The SEC did virtually nothing to investigate John Mack as the potential tipper for inside trading.[215]. Initially, the SEC Office of Inspector General (OIG) gave Aguirre's allegations little credence. [216] The Congressional Report noted that the OIG "failed to conduct a serious, credible investigation of

[207] PEQUOT REPORT, *supra* note 9.
[208] *Id.* at 1.
[209] *Insider Trading Hearing, supra* note 14 (Statements of Mr. Gary J. Aguirre, Former Investigator, SEC).
[210] *Id.*
[211] *Id.*
[212] PEQUOT REPORT, *supra* note 9, at 20.
[213] In the weeks after a conversation with CEO Mack and prior to the public announcement of GE's acquisition of Heller, Pequot's executive Arthur Samberg purchased over one million shares of Heller Financial stock and also shorted GE shares. On the day the deal was announced, Samberg sold all of the Heller stock. Samberg also covered the short positions in GE shortly thereafter, for a total profit of $18 million for Pequot in a matter of weeks. *Id.* at 5.
[214] *Id.*
[215] A single SEC subpoena was issued on the effective date of Aguirre's termination from the SEC. *See id.* at 5-6.
[216] *Id.* at 1.

Aguirre's claims,"[217] even though the trades deserved a through investigation. Only after the New York Times published Aguirre's allegations and Aguirre testified before Congress did the SEC begin to reevaluate its need to interview Mack.[218] The Congressional Report found that SEC officials were overly deferential to Mack because he was an industry leader.[219]

The SEC missed a great opportunity in the Pequot case to develop needed expertise into the operations of a major hedge fund. The visibility of a full SEC investigation could have also acted as a deterrent for major institutional investors who might engage in insider trading. The SEC must consistently demonstrate vigorous enforcement of the law to prevent market manipulation. Instead, the SEC squandered this opportunity through a series of missteps. The report stated that

> [a]mong the [SEC's] failings . . . were delays in the Pequot investigation, disclosure of sensitive case information by high-level S.E.C. officials to lawyers for those under scrutiny, a detrimental narrowing of its scope after a meeting with a Pequot lawyer, and the appearance of "undue deference'' to a prominent Wall Street executive that resulted in the postponement of his interview until after the case's statute of limitations had expired.[220]

Several recommendations were included in the Congressional Report. First, the SEC should standardize its investigative procedures.[221] Second, the SEC should have criteria for directing more resources to significant and complex cases.[222] Third, the SEC should issue guidance for supervisors to keep complete and reliable records of all outside communications regarding an

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[217] *Id.* at 6. The SEC's Office of the Inspector General conducted its investigation informally, via telephone, and accepted the supervisor's statements at face value. *Id.* at 97.
[218] *Id.* at 39.
[219] *Id.* at 37.
[220] Gretchen Morgenson and Walt Bogdanich, *S.E.C. Erred on Pequot, Report Says*, N.Y. TIMES, Aug. 4, 2007, at C1.
221 PEQUOT REPORT, *supra* note 9, at 7.
[222] *Id.*

investigation of possible securities violations.[223] Fourth, the SEC's Office of the Inspector General should have indepent and more thorough investigative procedures.[224]

In 2007, the SEC began to investigate the hedge fund industry's involvement in insider trading, following its formation of a Hedge Fund Task Force.[225] SEC document requests and surveys were sent to over two dozen hedge funds.[226] The SEC wanted to learn about the internal controls that exist to prevent insider trading.[227] "This has become a high-profile issue both inside and outside bankruptcy as the SEC continues to scrutinize the trading practices of hedge funds that lend to distressed companies and that may have access to nonpublic information."[228] The SEC is also examining "whether [hedge] fund representatives overstated their bond positions to gain membership on creditors' committees."[229] However, the questionable quality of the SEC's prior investigations into hedge fund trading activities raises serious concerns about ineffective government oversight of the industry and the government's ability to detect insider trading.[230]

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[223] *Id*. at 7-8.

[224] *Id.*

[225] The SEC previously conducted two investigations of the hedge fund industry. In 1998, following the collapse of Long Term Capital Management , the SEC investigated risk related issues presented by hedge funds. In 2003, the second SEC investigation focused on investor protection issues, such as valuation, conflicts of interest, and fraud. *See* SEC & EXCH. COMM., *supra* note 49.

[226] *See* Kara Scannell, *SEC Pushes for Hedge-Fund Disclosure; Advisers' Kinship to Firms' Workers, Investors Is Studied*, WALL ST. J., Sept. 19, 2007, at C3.

[227] The survey has raised concerns, according to Mark Schonfeld, Director of the SEC's New York Regional office. *See id.* Among the questions was a request to list companies where employees or affiliates of the investment adviser serve on a creditor committee. *Id.*

[228] Fisher & Buck, *supra* note 99.

[229] *See* Taub, *supra* note 97 ("The SEC is reportedly looking into whether fund representatives overstated their bond positions to gain membership on creditors' committees of distressed companies.").

[230] Cases brought by the SEC's Enforcement Division have tended to arise from tips, not SEC examination reports. *See* H. Norman Knickle, *The Investment Company Act of 1940: SEC Enforcement and Private Actions,* 23 ANN. REV. BANKING & FIN. L. 777, 807 (2004), *citing* John Kimelman, *Investing: No Consensus on Tighter Rules for Hedge Funds*, N.Y. TIMES, Oct. 26, 2003, at C6.

E. Limited International Efforts to Combat Insider Trading

With the international nature of many financial and business transactions in the twenty-first century, it is not sufficient to consider only U.S. securities law on insider trading to prevent such activities. Strong securities laws and enforcement in other countries having financial markets are important for the United States to have a cohesive approach to fighting insider trading.[231] The lack of a broad statutory definition of insider trading is a significant problem in the securities law. Refining the insider trading law similar to recent changes in the European Union and codifying it should make the securities law more easily understandable and raise voluntary compliance levels.[232]

In the 1990's, insider trading frequently arose around the world as countries developed more sophisticated financial markets.[233] Laws restricting insider trading were created not only in countries with major stock exchanges, but in various other countries as well.[234]

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[231] *See generally* Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31 (2007).

[232] *See Market Abuse Directive, infra* note 241.

[233] A generation ago, the United States was one of the few countries showing any desire to fight insider trading aggressively. *See* Robert A. Prentice, *The Internet and Its Challenges for the Future of Insider Trading Regulation*, 12 HARV. J.L. & TECH. 263, 347 (1999).

[234] *See, e.g.*, Jeremiah Burke, *Ireland Goes Bananas: Irish Insider Trading Law and Price Sensitive Information After* Fyffes v. DCC, 30 HASTINGS INTERN'L & COMP. L. REV. 453 (2007); Eric Cafritz and James Gillespie, *France Diverges From US on Insider Trading*, 22 INT'L FIN. L. REV. 58 (2003); Geoff Dyer, *China Issues Market Abuse Fine*, FT.COM, May 14, 2007, http://us.ft.com/ftgateway/superpage.ft?news_id=fto051420071726206152; Masanori Hayashi, *Japanese Insider Trading Law at the Advent of the Digital Age: New Challenges Raised by Internet and Communication Technology*, 23 HASTINGS COMM. & ENT. L.J. 157, 158 (2000–2001); David Kanarek and Susan Collier, *"Knew Or Should Have Known,": Lessons for the EU Securities Law Regime*, 10 COLUM. J. EUR. L. 561 (2004); Alexander F. Loke, *From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the U.K., Australia, and Singapore*, 54 AM. J. COMP. L. 123 (2006); Patrick C. Osode, *The New South African Insider Trading Act: Sound Law Reform or Legislative Overkill,* 44 J. AFR. L. 239 (2000); Sandeep Parekh, *Prevention of Insider*

By 2000, eighty-seven countries prohibited insider trading in selected circumstances.[235] Because the SEC has recognized the advantage of minimizing differences in securities laws among countries,[236] the SEC has lobbied securities regulators in various countries to enact laws and enforce prohibitions against insider trading.[237] However, insider trading laws continue to differ in detail and their enforcement.[238] Differences in the law are particularly apparent in determining "when it is illegal for a party in possession of

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Trading and Corporate Good Governance in India, 32 INT'L BUS. LAW. 132 (2004); Mohd Ishaque Qureshi, *Regulatory Mechanisms of Securities Trading in Malaysia (with Special Reference to Insider Trading)*, 4 PAC. RIM L. & POL'Y J. 649 (1995) (stating that in 1993 Malaysia established a Securities Commission to offer greater regulatory oversight and control insider trading); Richard Small, *From Tatemae to Honne: A Historical Perspective on the Prohibition of Insider Trading in Japan*, 2 WASH. U. GLOBAL STUD. L.REV. 313 (2003); Anna Y.M. Tam, *Financial Orders Under Subsections 23(1)(b) and (c) of the Securities (Insider Dealing) Ordinance:*Insider Dealing Tribunal v. Shek Mei Ling, 30 HONG KONG L.J. 22, 27 (2000); Chiu Hse Yu, *Australian Influences on the Insider Trading Laws in Singapore*, 2002 SING. J. LEGAL STUDIES 574 (2002).

[235] *See* Utpal Bhattacharya and Hazem Daouk, *The World Price of Insider Trading,* 57 J. OF FINANCE 75, 77 (2002) (stating that 103 countries had stock markets at the time of the paper, and that of those 87 had insider trading laws, which were enforced in varying degrees). As of 1999, only thirty-eight countries had attempted to enforce their insider trading laws. *Id.*

[236] Policy Statement of the Securities and Exchange Commission on the Regulation of International Securities Markets, Securities Act Release No. 6807, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,341 (Nov. 14, 1988).

[237] *See generally* George C. Nnona, *International Insider Trading: Reassessing the Propriety and Feasibility of the U.S. Regulatory Approach*, 27 N.C. J. INT'L L. & COM. REG. 185 (2001–2002) (discussing SEC lobbying of foreign governments to enact U.S.-style securities regulation as "implementation on a global scale of securities legislation based on the U.S. model. It has achieved this through a combination of lobbying and pressure brought to bear on the regulatory authorities of different jurisdictions.").

[238] *See* Ramzi Nassier, *The Morality of Insider Trading in the United States and Abroad*, 52 OKLA. L. REV. 377 (1999). *See generally* Joseph J. Norton, *Global Financial Sector Reform: The Single Financial Regulation Model Based on the United Kingdom FSA Experience: A Critical Reevaluation*, 39 INT'L LAW. 15 (2005).

information unknown to the other side to buy or sell stock without first disclosing the [inside] information."[239]

The European Union (EU) has recognized the importance of prohibiting insider trading. In 1989, the EU's predecessor, the European Economic Community, first passed a directive requiring its member countries to adopt insider trading legislation.[240] The EU subsequently updated its insider trading laws in 2003 in its *Market Abuse Directive*.[241] The Market Abuse Directive defines "inside information" more broadly than previous EU issuances. Inside information includes certain kinds of private information, which, if made public, would have a significant effect on the price of either the financial instruments or related derivatives. The EU Directive broadened the application of insider trading concerns from "transferable securities" to "financial instruments" in order to take account the development of new products. The problem addressed by the EU's Market Abuse Directive was that "new financial and technical developments enhance the incentives, means and opportunities for market abuse," such as insider trading.[242]

In 2001, the United Kingdom (U.K.) established the Financial Services Administration (FSA) to centralize securities enforcement powers[243] Prior to the FSA's creation, the U.K. had prosecuted relatively few insider trading cases.[244] Three major

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[239] *See* Franklin Gevurtz, *The Globalization of Insider Trading Prohibitions*, 15 TRANSNAT'L LAW. 63, 68 (2002).

[240] Council Directive 89/592, Coordinating Regulations on Insider Dealing, 1989 O.J. (L. 334) 30.

[241] The Market Abuse Directive is technically four directives and one regulation enacted by the European parliament. Council Directive 2003/6 2003 O.J. (L. 141) is common known, on its own, as the Market Abuse Directive.

[242] Communication from the Commission: Implementing the Framework for Financial Market: Action Plan, at 15, COM (1999) 0232 final (May 11, 1999). Market abuse has occurred through exploitation of "new products, new technologies, increasing cross-border activities and the Internet." *See generally* Emilios Avgouleas, *A Critical Evaluation of the New EC Financial-Market Regulation: Peaks, Troughs, and the Road Ahead*, 18 TRANSNAT'L LAW. 179 (2005) (providing background on the EU's Action Plan for Financial Services).

[243] *See generally* Fin. Serv. Auth., About the FSA, http://www.fsa.gov.uk/Pages/About/Who/History/index.shtml (last visited Dec. 1, 2008).

[244] Speech by Newkirk & Robertson, *supra* note 20 ("[In] [t]he U.K. system . . . [e]nforcement and regulation powers were spread among separate front-

reasons for the dearth of prosecutions were that insider trading was only a criminal offense, which made successful prosecutions very difficult; the U.K.'s definition of insider trading was too tightly drawn; and a more modern *Code of Market Conduct* was needed in the U.K. to help prevent insider trading.[245] The FSA believes that in recent years some hedge funds are testing the boundaries of acceptable business practices.[246] However, even the FSA's recent, more rigorous activities seem insufficient in preventing insider trading by hedge funds.[247]

The International Organization of Securities Commissions (IOSCO)[248] has three core objectives: protecting investors; ensuring markets are fair and efficient; and reducing systemic risk.[249] To ensure fair markets, IOSCO established principles to further international cooperation in securities law enforcement.[250] In 2005,

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line regulators responsible for particular sectors of the market . . . ."). *See generally* Joseph J. Norton, *Global Financial Sector Reform: The Single Financial Regulation Model Based on the United Kingdom FSA Experience—A Critical Reevaluation*, 39 INT'L LAW. 15 (2005) ("[P]rovid[ing] . . . background and policy information . . . [on] the *pros* and *cons* of the adoption of an FSA mega-regulator structure.").

[245] Speech by Newkirk & Robertson, *supra* note 20.

[246] Margaret Cole, Director of Enforcement, Fin. Serv. Auth., The UK FSA: Nobody Does It Better? (Oct. 17, 2006), *available at* http://www.fsa.gov.uk/pages/ Library/Communication/Speeches/2006/1017_mc.shtml.

[247] Lina Saigol, *City Must Join Insider Trading Fight*, FIN. TIMES, Apr. 23, 2007, at 19 ("The FSA is a toothless white elephant. No one thinks they are going to get caught, and if they do, the worst that can happen is a fine.").

[248] Int'l Org. of Sec. Comm'ns, *IOSCO Historical Background,* http://www.iosco.org/about/index.cfm?section=history (explaining that IOSCO consists of securities regulators from nearly one hundred jurisdictions spanning more than ninety percent of the world's securities markets).

[249] INT'L ORG. OF SEC. COMM'NS, OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION (2003), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD1 54.pdf; *see also* INT'L ORG. OF SEC. COMM'NS, TECHNICAL COMM., THE REGULATORY ENVIRONMENT FOR HEDGE FUNDS: A SURVEY AND COMPARISON (FINAL REPORT) 13 (2006) [hereinafter IOSCO SURVEY], *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD226.pdf.

[250] *See, e.g.*, Int'l Org. of Sec. Comm'ns, *Principles for Record Keeping, Collection of Information, Enforcement Powers and Mutual Cooperation to Improve the Enforcement of Securities and Future Law* (Oct. 1994), *available at* www.iosco.org/library/resolutions/pdf/IOSCORES11.pdf (last

IOSCO released a report that noted that internationally accepted regulatory principles were not universally adopted[251] and enforcement efforts were hindered by the inability to exchange information and coordinate securities investigations across borders.[252] IOSCO's leadership to combat insider trading is critical in promoting a coordinated international approach against such fraud. Yet, the lack of international enforcement of securities law, which can affect the global financial system, requires a new system for assuring the survival of the international financial system in times of crisis.

V. Solutions for Reducing Insider Trading by Hedge Funds

Hedge funds often provide greater opportunity for securities fraud than most entities. The factors that make hedge funds conducive to insider trading make it relatively easy to conceal any insider trading.[253] The SEC has focused on an industry solution to the insider trading problem. However, it does not address the increasing willingness of investors to use an exchange in another country for part of the camouflage; legislative and international solutions are also needed.

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visited Dec 1, 2008). *See generally* Mann & Barry, *supra* note 36, at 673 ("[R]egulators have joined such organizations as [IOSCO] to establish principles that form the basis for further cooperation in securities enforcement.").

[251] Press Release, Int'l Org. of Sec. Comm'ns, Final Communiqué of the XXXth Annual Conference of the International Organization of Securities Commissions (Apr. 7, 2005) ("Since October 2004, an IOSCO committee has been working to identify jurisdictions that appear to be unable or unwilling to co-operate . . . .").

[252] Jane Diplock, Chairman, Int'l Org. of Sec. Comm'ns Executive Comm. and N.Z. Sec. Comm'n, Speech at the 17th Asian Pacific Conference on Accounting Issues: IOSCO Response to Accounting Scandals (Nov. 21–22, 2005), *available at* http://www.seccom.govt.nz/speeches/2005/jds221105.shtml.

[253] Derivatives are treated differently under bankruptcy law than other assets. The rationale for the special treatment of derivatives is to prevent the insolvency of one commodities firm from spreading to other brokers. *See* 11 U.S.C. § 362(b)(6) (2000) (stating that the filing of a petition under the statute does not serve as a stay against any "contractual right under any security agreement or arrangement or other credit enhancement" held by holder of the security).

A. Desired Industry, Regulatory, Legislative, and International Reforms

Industry standards are useful in helping to shape the securities regulation that should exist to prevent insider trading. The United Kingdom's hedge fund industry has taken the lead and proposed several industry standards. The Hedge Fund Working Group has proposed standards with best practices and recommended procedures to deal with issues such as necessary disclosures, internal procedures to comply with market abuse laws, and contingency plans in the case of market abuse. Below is the recommended procedure for receipt of inside information:

- First, notify the hedge fund's compliance officer if an employee believes (s)he has received inside information;
- Second, the compliance officer must determine whether the information is material and nonpublic;
- Third, if the information is material and nonpublic, the securities are placed on a restricted list;
- Fourth, the entire hedge fund is excluded from dealing in securities placed on the restricted list;
- Fifth, Chinese Walls are needed to prevent individual portfolio managers who are members of a creditors committee of a financially distressed company from trading in that company.[254]

These industry standards should also apply to all hedge funds that trade securities on exchanges in the United States.

In 2008, the SEC proposed industry solutions for better insider trading surveillance, investigation, and enforcement.[255] The

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[254] *See* HEDGE FUND WORKING GROUP, HEDGE FUND STANDARDS: PART II THE BEST PRACTICE STANDARDS 59 (Oct. 9, 2007) [hereinafter HFWG II], *available at* hfwg20consultation20paper20part20ii.pdf (last visited Dec. 1, 2008).

[255] *See* Program for Allocation of Regulatory Responsibilities, Exchange Act Release No. 58,350, Fed. Sec. L. Rep (CCH) ¶ 88,254 (Aug. 13 2008). SROs have the power to propose to the SEC joint plans for the allocation of regulatory responsibilities. *See* 17 C.F.R. § 240.17d-2 (2007). The SEC can

SEC's industry proposal is to have the securities exchanges operating in the United States use centralized enforcement. Two years earlier, a similar arrangement was mandated among the securities options exchanges.[256]

In 2008, the SEC signaled that it will investigate entities "whose policies and procedures could have prevented insider trading."[257]Thus, the SEC now expects all market participants, such as hedge funds, to demonstrate an effective compliance program against insider trading.[258]

Imposing an industry solution is helpful for part of the problem, but not all of it; further regulatory solutions are needed. Regulating hedge fund advisers is needed in order to provide proper governmental oversight of hedge funds, such as preventing insider trading. Regulation would help deter their potential involvement in insider trading and other securities fraud.[259] Registration of hedge fund advisers would make their hedge funds subject to various securities rules and regulations, such as requiring a compliance officer. Especially given the enormous financial incentives for hedge funds to skirt compliance with the securities law, greater internal controls are needed within the hedge fund industry. It is not enough to rely on just the proposed industry standards to enforce compliance with the expected behavior.[260]

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mandate the proposal if the SEC determines the plan is in the public interest for the protection of investors or to further develop the market system.

[256] *See* Joint Industry Plan, Exchange Act Release No. 53,940, 71 Fed. Reg. 34,399 (June 14, 2006) (outlining "a plan providing for the joint surveillance, investigation and detection of insider trading on the markets maintained by the [option exchanges]").

[257] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The Retirement Systems of Alabama, Release No. 57,446 (Mar. 6, 2008) *available at* http://www.sec.gov/litigation/invest report/34-57446.htm [hereinafter Release 34-57446]. This investigative signal arose in a Section 21(a) report resolving its investigation of the Retirement System of Alabama. *See* Michael K. Lowman et al., *Keeping Current: Securities*, 17 BUS. L. TODAY 64 (July/Aug. 2008).

[258] *See* Lowman et al., *supra* note 257, at 63.

[259] *See Insider Trading Hearing, supra* note 14 (statement of Richard Blumenthal) ("Companies must provide stronger tools for the SEC to promote hedge fund management and disclosure of critical information.").

[260] Various industry standards have existed for many years, such as the "Global Investment Performance Standards." *See, e.g.*, Global Investment Performance Standards, www.gipsstandards.org (last visited Dec. 1, 2008).

Several legislative reforms in the United States are needed to prevent and effectively prosecute insider trading, especially when conducted by hedge fund employees. Effective, prudent, and non-bureaucratic SEC regulation of hedge funds is needed to deter insider trading fraud and to assure efficient markets. These reforms include broadening the statutory law define insider trading, regulating hedge fund advisers, and regulating derivatives or other financial transactions more efficiently and effectively, both domestically and internationally.[261]

The lack of a statutory definition broadly defining insider trading is a significant problem in U.S. securities law. Refining the insider trading laws similar to recent changes in the European Union and codifying it should make the securities law more easily understandable.[262] Knowledge of the securities law is especially important for business executives and financial professionals who need to understand the prohibited conduct regarding insider trading. Widespread knowledge of the law assists in its proper enforcement. Insider trading is an important problem that Congress should not ignore and leave to ineffectual SEC regulation and enforcement.

Congress can and should address the insider trading problem more broadly than recent Supreme Court decisions. Congress must enable private parties to hold gatekeepers liable for furthering financial fraud. It is time for Congress to follow the SEC's previous appeal to Congress to fully restore private parties' rights to sue against gatekeepers aiding and abetting fraud. The SEC should continue its lobbying efforts in Congress to strengthen the necessary fight against securities fraud.[263]

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[261] Stronger whistle-blowing provisions are needed to encourage the confidential reporting of wrongful insider trading. Protection from retaliation is desirable, but at a minimum an effective and speedy remedy should exist to offset any economic harm from probable retaliation. Financial incentives should exist to reward those who provide critical information leading to successful prosecution of insider trading. *See Insider Trading Hearing, supra* note 14 (statement of Ronald J. Tenpas, Assoc. Deputy Att'y Gen. of the United States).

[262] *See supra* notes 240-42 and accompanying text.

[263] COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, REPORT ON THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, S. REP. NO. 104-98, at 47-48 (1995) (discussing SEC lobbying efforts to have congress overturn the Supreme Court's decision in *Lampf v. Gilbertson,* 501 U.S. 350 (1991), regarding statutes of limitation in securities fraud actions).

Congress should consider the Secretary of the Treasury's 2008 proposal to consolidate regulatory agencies of various financial markets, such as the SEC and the Commodity Futures Trading Commission.[264] This proposal is similar to the UK's 2001 consolidation of regulators into the Financial Services Agency.[265] Consolidation of financial market regulators is needed in the United States for proper oversight and enforcement of financial market participants, such as hedge funds who are able to cross various financial markets easily and exploit differences in their regulation.[266] A comprehensive unified regulatory agency can best assure consistency and fairness in financial regulation and better enforcement measures across financial markets.[267]

Stronger international coordination of securities fraud investigations is needed, including insider trading by hedge funds.[268] The need for international cooperation in the financial system became most apparent in mid-September 2008 when the sub-prime mortgage crisis led to the need to create a new federal government

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[264] DEP'T OF THE TREASURY, BLUEPRINT FOR MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008), *available at* http:// www.treas.gov/ press/releases/reports/Blueprint.pdf.

[265] *See supra* notes 247-47 and accompanying text.

[266] Commodity pools are regulated by the Commodity Futures Exchange Commission, of which many are hedge funds. Bank collective trusts are regulated by the Comptroller of the Currency. Pension funds are regulated by the Pension Benefit Guaranty Corporation and Department of Labor. Mutual funds are regulated by the SEC. *See* Roberta S. Karmel, *The SEC at 70: Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility: What Regulation by the Securities and Exchange Commission is Appropriate*, 80 NOTRE DAME L. REV. 909, 912 (2005).

[267] "Too little regulation, and investors demand a premium for their money, to compensate them for the greater risks they face in a lawless market. Too much regulation, and the costs outweigh the benefits—robbing investors of return and making markets less efficient." Christopher Cox, Address to the Securities Traders Assoc. 11th Ann. Wash. Conf., May 9, 2007, at 2.

[268] The continued need for strengthening cross-border information sharing was recognized in a meeting of market regulators with the NYSE. *See Illegal Insider Trading: How Widespread Is the Problem, Hearing Before S. Comm. on Judiciary*, 109th Cong. 10 (2006) (statement of Robert Marchman, Executive, Vice President, N.Y. Stock Exchange) ("The history of the securities markets teaches us that insider trading is a serious regulatory concern, particularly today, where the volume, complexity of trades, and products, as well as crossborder transactions are redefining capital markets on almost a daily basis.").

trust fund to prop up the banking system, teetering on the verge of collapse.

While IOSCO helps to encourage international coordination in securities regulation, IOSCO's guidance and voluntary agreements to date are not enough, especially given the complexities of the global financial markets. The World Trade Organization should incorporate IOSCO standards on securities laws in order to provide a stronger international enforcement mechanism for countries to assure that governments provide more effective securities laws and enforcement of these laws.

B. Ensuring More Integrity Within a Creditors Committee

Hedge funds must recognize that investors and the public have become more interested in monitoring their activities, particularly given the rise in the hedge fund industry's financial size and power.[269] A creditors committee operates as a constructive insider in a financially distressed corporation when it receives confidential corporate inside information. Misuse of that information is not only a breach of the committee's fiduciary powers, but harmful to the integrity expected throughout the financial markets. Insider trading laws should apply to those serving on creditor committees who misappropriate confidential inside information.

In order to reduce the risk of securities law violations by hedge fund employees, hedge funds need more regulatory oversight.[270] Lax governmental regulation of hedge funds helped to remove their trading activities from some SEC investigations.[271]

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[269] *See* HFWG II, *supra* note 254, at 9 (discussing the factors to be looked at in determining "whether the commercial terms applicable to a particular hedge fund are disclosed in sufficient detail and with sufficient prominence in the fund's offering documents/marketing materials to enable investors to make informed investment decisions").

[270] *See generally* Thomas C. Pearson and Julia Lin Pearson, *Protecting Global Financial Market Stability and Integrity: Strengthening SEC Regulation of Hedge Funds*, 33 N.C. J. INT'L L. & COMM. REG. 1 (2007) (surveying the history of hedge fund enforcement and the effects of its relative paucity).

[271] The current limited regulatory oversight over all hedge funds includes a recently created antifraud rule, as well as indirect regulation through the Federal Reserve. Investment advisers are subject to an anti-fraud rule, whether the adviser is registered or not. *See* Investment Adviser Act of 1940

Regulation of hedge fund advisers would enable the SEC to conduct "reasonable periodic, special, or other examination[s]" of all records maintained by any adviser.[272]

Insider trading law has evolved over the years, both in the United States and internationally. In part, the securities law and its increasing enforcement reflects the realities that the business environment has become more complex and the capital markets use various sophisticated financial instruments. More rigorous enforcement of the securities laws is generally needed to monitor and control adverse effects of structured financial products. This includes returning the SEC to vigorous investigations of suspect trading activities, even when such investigations are conducted in hedge funds overseen by prominent individuals or prestigious firms.

Eventually, courts are likely to broaden the application of insider trading laws to those who are misappropriating the use of creditor information, even if Congress fails to statutorily codify insider trading.[273] When new Supreme Court justices are appointed

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§ 206(4), 15 U.S.C. § 80b-6 (2000); 17 C.F.R. § 275.206(4)-7 (2007) (criminalizing the making of any untrue material statement, or an omission of a material fact, by "any investment adviser"). In 2006, the D.C. Circuit Court of Appeals overturned the SEC's attempt to register most hedge fund as investment advisers. *See* Goldstein v. Sec. & Exh. Comm'n, 451 F.3d 873 (D.C. Cir. 2006) (holding that the SEC's attempt to regulate hedge fund managers based on a broad reading of the word "clients" in the Advisers Act was an overbroad use of the SEC's power).

[272] *See* Investment Advisers Act § 204, 15 U.S.C. § 80b-4. Registered investment advisers must have written policies and procedures designed to prevent the misuse of material nonpublic information. *See* Investment Advisers Act of 1940 § 204A, 15 U.S.C. § 80b-4a. If hedge fund advisers register with the SEC, then they must conduct their own annual reviews of the funds' compliance program. *See* 17 C.F.R. § 275.206(4)-7 (discussing the requirements to be an investment adviser in compliance with SEC rules, including annual review of the fund's compliance policies and procedures); *see generally* Press Release, Gene A. Gohlke, Examiner Oversight of "Annual" Review Conducted by Advisers and Funds (Apr. 7, 2006), *available at* http://www.sec.gov/info/cco/ann_review_oversight.htm (last visited Dec. 1, 2008) ("The touchstone for examiners in evaluating a firm's annual review will be - did the firm's annual review result in the firm continuing to have a set of compliance policies and procedures that effectively prevent compliance problems, find those problems that happen and promptly correct the issues that occur.").

[273] In the interim, companies should have visible policies prohibiting insider trading, while managers should reinforce the expected conduct. *See* Goelzer

by future Presidents, the next round of a broader application of insider trading law should occur.

VI. Conclusion

Although Congress addressed insider trading a generation ago, it must revisit the securities fraud law to tackle modern day challenges. More sophisticated technology, internationalization, and complex hedge fund characteristics increase the possibility of insider trading problems. The SEC must take aggressive action to deter and detect sophisticated insider trading concealed across the global financial markets. This need is particularly important in the unregulated world of hedge funds that are dominating the leading securities markets. All participants in the capital markets should have a level playing field with access to the same basic information.

Hedge funds serving on a creditors committee obtain access to nonpublic information. Therefore, hedge funds must exercise enormous care so as not to allow any of its traders or hedge fund employees to use information gained from those committees to achieve the enormous financial returns that investors have come to expect from hedge funds. Hedge funds should face liability similar to other professional fiduciaries when they function on creditor committees.

Knowledge of the securities law is especially important for business executives and financial professionals who need to understand the prohibited conduct regarding insider trading. Widespread knowledge of the law assists in its proper enforcement. Sophisticated insider trading is an important problem that Congress must not ignore and merely leave to the current ineffectual SEC regulation and enforcement. Industry and international solutions are also needed to reduce financial market manipulation, especially through insider trading.

Because insider trading harms the public's faith in the integrity of the financial markets, clear statutory laws and strong governmental enforcement of insider trading laws are needed. It is important that the law enables fiduciaries to assist the proper operations of the financial markets. Investors and the public cannot rely on the integrity of hedge funds alone where hedge funds yield enormous economic leverage. Too often, judgments in the financial

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& Brejcha, *supra* note 145, at "Part VIII: Structuring a Corporate Compliance Program for Nonpublic Information."

system are swayed by the enormous financial returns that the hedge funds often provide.