The Economist

Insider trading on Wall Street

Outside the law

A government investigation shakes the hedge-fund industry

Nov 25th 2010 | NEW YORK | from PRINT EDITION

IN A SPEECH in October, Preet Bharara, federal prosecutor for the Southern District of New York, laid out his plans to root out insider trading, which he compared to a "performance-enhancing drug". Some of the hedge-fund industry's top brass may soon stand accused of using what Mr Bharara called "financial steroids". On November 22nd the Federal Bureau of Investigation (FBI) raided three hedge funds as part of a sweeping investigation into insider trading that could prove to be the largest that the industry has ever faced.

Several well-known hedge funds, mutual funds and consulting firms have already been ensnared and the list of firms from which the government is demanding information continues to grow. Some are related to SAC Capital Advisors, a big outfit run by Steven Cohen, one of the industry's most famous managers. Two of the hedge funds that FBI officials visited, Diamondback Capital Management and Level Global Investors, are headed by former SAC traders, one of whom is also Mr Cohen's brother-in-law. SAC itself has received a subpoena from the federal government, which has made a request for broad swathes of information.

By November 24th only one person had been arrested and charged with securities fraud: Don Ching Trang Chu, an employee at an "expert networking firm". These firms, which purport to provide consulting services, enable investors to pay them for advice on specific companies and industries, some of which may include non-public information. Many hedge funds are likely to suspend dealings with these firms while details of the investigation are sorted out. The probe could also dent hedge funds' nascent recovery by causing spooked investors to withdraw their money. The winners include lawyers and public-relations firms, which are seeing a surge in demand for their services, according to one hedge-fund executive.

The Securities and Exchange Commission (SEC) has scaled up its oversight since its failure to spot Bernie Madoff's Ponzi scheme, which came to light in 2008. Its investigation of Galleon Group, a large hedge fund, has resulted in charges against around two dozen people, including Raj Rajaratnam (pictured), the fund's billionaire boss, who is due to face trial in January. He denies wrongdoing.

The Galleon case showed that "paying for information from a variety of inside sources was an established practice", says Robert Khuzami, the SEC's director of enforcement. As a result, the SEC is focusing on prosecuting broader networks of people involved in insider trading, not just narrow rings and individuals. It is also employing methods, such as wiretaps, that are used to fight other kinds of criminal activity, and is reimbursing whistle-blowers more handsomely.

Hedge funds should expect further scrutiny. The SEC is hiring hordes of officials to help monitor large outfits, which, because of a provision in America's financial reform bill, will have to register next year. Funds will have to disclose more information to the SEC about their positions and retain all records.

Raj against the machine

The SEC is hoping these changes will help it spot jiggery-pokery more easily. But the speed of trades, and the frequency with which many hedge funds move in and out of positions, can make it difficult to prove insider trading.

It can also be challenging to define what distinguishes insider information from diligent research. It is obviously illegal to buy information about a merger before it is announced. But is it also illegal to buy information about the number of customers going into a retailer, and trade using those data?

Joseph Grundfest, a professor at Stanford University and former SEC commissioner, thinks that through this investigation the SEC may be trying to "expand traditional conceptions" of what constitutes insider trading. But it is still unclear what information was actually peddled. For the time being, nervous firms will have to wait for more subpoenas to be issued and more charges to be brought.

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