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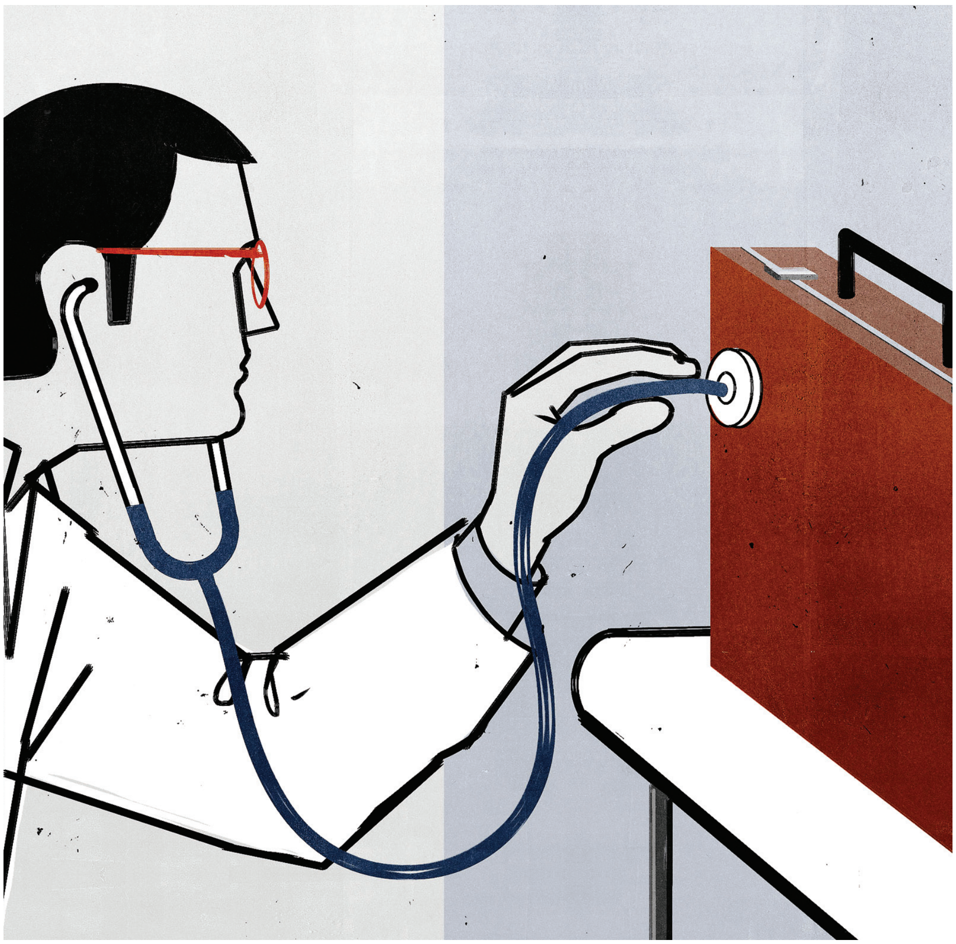
Taking a closer look at the experts

Some hedge funds have been ditching third-party research providers as questions linger about just what constitutes insider trading

/ By Britt Erica Tunick



In late November, just days after the Federal Bureau of Investigation raided hedge fund firms Diamondback Capital Management, Level Global Investors and Loch Capital Management, the phones went silent at the third-party research firms and expert networks that had been working with $1.8 billion Balyasny Asset Management.

Balyasny didn't take long to reveal the reason for its sudden silence. Having received a subpoena as part of the government's widespread investigation of insider trading within the hedge fund community, along with firms including SAC Capital Advisors and Citadel, Balyasny announced that it was tabling its use of research firms and expert networks until it could be certain that those relationships would not make the firm a potential target for the government.

"We just think it's prudent right now, given everything that's going on, to put a pause on our external relationships," Barry Colvin, a vice chairman at Balyasny, said of his firm's decision. "We do a review every year of our use of consultants and the relationships with them. And since our review was coming up pretty soon anyway, we just decided to move it forward a bit," added Colvin. And Balyasny, whose decision was first reported on *AR*'s website, is not alone.

As the government continues its investigation of the hedge fund industry, and as an increasing number of arrests are made, many hedge fund firms have begun reevaluating their relationships with third-party research firms and expert networks—firms that specialize in connecting investors with experts within the industries and fields they are focused on. These include medical doctors knowledgeable about the latest research and developments, particularly possible U.S. Food and Drug Administration approvals. The government's suspicions regarding the practices of third-party research firms are nothing new, particularly when it comes to the "experts" at the heart of expert networks' operations, who are often privy to confidential information. But as regulators have stepped up their oversight of the types of information such experts share, the risks inherent in such relationships have been highlighted.

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> Harry Davis, Schulte Roth & Zabel

In August the FBI questioned an individual employed by Gerson Lehrman Group, the expert-network industry's oldest and largest firm. Gerson's business model was first questioned in a 2005 article in the *Seattle Times* focusing on the firm, which was then subpoenaed in early 2007 as part of an investigation into third-party research firms by the Securities and Exchange Commission and the New York attorney general's office.

On November 2 the SEC charged Yves Benhamou, a Paris doctor who specializes in liver diseases, for tipping off a fund manager at Morgan Stanley subsidiary FrontPoint Partners about negative unpublished findings of a drug trial in early 2008. And fallout from the October 2009 charges levied against Galleon Group continues to mount. Early last month the SEC filed civil charges against hedge fund firm Trivium Capital Management and the firm's co-founder Robert Feinblatt; Jeffrey Yokuty, a Trivium analyst; Sunil Bhalla, a former executive at technology company Polycom; and Shammara Hussain, a consultant at investor relations firm Market Street Partners who did work for Google.

The number of individuals charged as part of the Galleon case now totals 24, with 17 people having pleaded guilty so far. The latest big name to plead out was Danielle Chiesi, who had worked for hedge fund New Castle and also had close ties to Galleon's founder Raj Rajaratnam.

When it comes to research firms, Primary Global Research—an expert-network firm whose specialty areas include health care, technology, financial services, energy, real estate and alternative energy—has been hit hardest by the government's probe.

So far, seven people affiliated with Primary Global have been charged with insider trading activities, most recently in mid-December, when the FBI arrested four individuals tied to the firm and accepted a guilty plea from a fifth for charges ranging from conspiracy and wire fraud to providing confidential information.

As a result of regulators' heightened oversight and the latest arrests in the insider trading investigation, hedge funds are reexamining which research practices could potentially be deemed insider trading. "The SEC is constantly trying to push the envelope in terms of the line between good permissible research and insider trading," says Harry Davis, a partner at law firm Schulte Roth & Zabel.

"The law in this area has developed through case law—decisions made by judges in cases brought by the SEC and the Department of Justice. For its part, the SEC has continued its mission by trying to bring cases it believes are appropriate, which include cases that seek to expand the law in this area," he says.

According to the SEC's definition, illegal insider trading "refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. Insider trading violations may also include 'tipping' such information, securities trading by the person 'tipped,' and securities trading by those who misappropriate such information."

The Internet and heightened public disclosure requirements have made more information available on publicly listed companies. As a result, some of the more aggressive research tactics have occasionally strayed into gray areas.

One popular research method hedge funds have been utilizing is known as mosaic theory, which involves a process of looking at multiple pieces of information—both public information and nonpublic nonmaterial information—in order to create a thesis for a specific company. Such research is not limited to facts and can include the opinions of individuals in a company's specific sector.

"In a world of black and white, [mosaic theory] is very firmly in the white category. It's the type of good research one would expect of anyone, especially one who is a fiduciary," Davis says.

He notes that the U.S. Supreme Court endorsed the importance to the securities markets of good research in the 1983 case of Dirks vs. the SEC. But with so much information available these days, hedge funds are trying to make sure that the nonpublic material that is part of such research would truly be deemed nonmaterial by regulators.

The line can get a bit blurrier with another popular research tactic, known as channel checks. In this case, analysts examine the channels used to distribute a product or service to determine retail demand and potential revenue, which can directly affect share price. Using this approach, a researcher trying to form an opinion of a company that produces handheld computers might head to stores that carry the devices to observe customers' reactions to the product.

Davis says that the practice falls within regulators' definition of permissible activity—as long as researchers don't compel employees of a store to reveal sales information that would otherwise remain confidential and create a situation that could be considered insider information.

Beyond the research practices that hedge fund firms rely on for their investment activities, there is a strain of thinking within the industry that the real target of the government's investigation is Steve Cohen's SAC, one of the hedge fund industry's biggest users of third-party research firms and expert networks. Cohen's trading practices have long been controversial.

SAC reportedly spends as much as $400 million of annual trading commissions to ensure that its information network—which has included expert-network firm Gerson Lehrman—all but guarantees that SAC traders receive the first news of anything to do with the companies they follow.

In January 2009 the SEC filed a complaint against former Blackstone Group managing director Ramesh Chakrapani, who is said to have given information about Supervalu's 2006 acquisition of grocery chain Albertsons to his friend Jonathan Hollander, a trader at SAC's CR Intrinsic Investors, which takes longer-term positions than the main SAC fund.

SAC turned Hollander in after an internal investigation uncovered his activities, yet industry observers and some former SAC employees believe the firm was simply trying to allay regulators' suspicions about its practices. And after regulators began paying a bit too much attention to SAC's research network roughly two years ago, the firm said it had severed ties to several of the expert networks it had been using. SAC has repeatedly denied all accusations of any wrongdoing.

Although landing a big fish like Cohen would no doubt make any prosecutor's career, some think it's coincidental that SAC has been tangentially connected to the scandals. Ron Geffner, a partner at law firm Sadis & Goldberg, believes SAC has simply found itself caught up in the insider trading scandal that brought down Galleon in 2009. SAC has been loosely tied to Galleon's demise since regulators revealed that Richard Choo-Beng Lee, a cooperating witness in the case, was a former SAC trader who agreed to provide details of any insider trading activities he may have participated in during the decade before his arrest, including several years at SAC.

Lee's cooperation with the government led to this past November's arrest of Don Ching Trang Chu, an employee of Primary Global, for allegedly passing on insider information. Five more employees of Primary Global have since been charged as part of the government's insider trading investigation, making it one of the few research firms to have lost several clients in recent weeks.

"The principals of hedge fund firms have had a shot fired across their bow, and they run the risk of not only being prosecuted for their own individual actions, but potentially being prosecuted for the actions of their subordinates," says Geffner, noting that it is not surprising hedge fund firms are trying to distance themselves from research firms or expert networks whose names have been tarnished by the insider trading investigation.

"Under Dodd-Frank's aiding-and-abetting violations, the standard-of-care burden has broadened," he says, meaning that hedge funds could potentially be held liable for actions of their third-party research partners considered to be insider trading, even if they are unaware of them.

The more popular theory among hedge funds—and one many larger firms with well-documented compliance practices have been using to try to gain an edge over their competitors—is that the government may be attempting to expand the definition of insider trading beyond the existing laws. "There is some thinking that the SEC may not be trying to change the insider trading definition, but that the attorney general may have a different agenda," says Michael Mayhew, chairman and director of research for Integrity Research Associates, which tracks the research industry.

Jay Gould, a partner at Pillsbury Winthrop Shaw Pittman, believes the government's investigation is little more than an effort to enforce the insider trading rules initially established as part of the Securities Exchange Act of 1934, and any adaptations since, to ensure that the public securities markets are transparent and that everyone is working from the same information.

"If you have people who are trying to undermine that theory, it isn't good for the capital markets, and it doesn't promote efficiency and fairness," says Gould. "There's nothing wrong with legitimate research, and there's nothing wrong with an organization that puts legitimate consultants and people who are experts in their fields in touch with people who are trying to learn that area or find out about a particular set of circumstances," he adds.

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Michael Mayhew, Integrity Research

By educating hedge fund firms about its practices, the research industry has been aggressively trying to distance itself from its few members who have been embroiled in the insider trading scandals. According to Mayhew, many research firms have hired law firms to review their compliance processes and produce reports on the findings for hedge fund clientele. What hedge funds are looking for is evidence that employee training at research firms and expert networks details what is and is not considered insider trading and that individuals are contractually held accountable to follow regulators' guidelines.

"One of the really big questions that is outstanding is not just, do the firms have policies or procedures that are appropriate to protect their clients, but do they actually do them and do they have a culture within the organization that is compliance focused," says Mayhew.

Because of that, he says, many hedge funds have taken to asking the research firms they partner with to complete annual and sometimes even biannual questionnaires about their compliance practices. These surveys can include up to 50 different questions on firms' efforts to ensure they are compliant with regulators' guidelines.

"Firms are trying to make sure they've got a handle on their own internal compliance policies and, at the same time, are doing audits of their research partners' policies." Nonetheless, he says the impact of the government probe has actually been less significant for researchers than might be expected.

Though a handful of firms (such as Loch Capital Management) have followed the lead of Balyasny and temporarily stopped using expert networks, they have lost few clients overall. Since news broke of the government's latest round of raids and subpoenas, transaction volume across the entire research industry is down less than 5%, according to Integrity Research.

The full impact of the scandals on firms is uncertain. FrontPoint was hit with redemptions of as much as $3 billion and was forced to liquidate its health care fund after one of its managers was linked to the scandal. Yet in early January the firm raised more than $1 billion for a new loan fund. Weeks later, however, Steven Eisman, one of the firm's highest-profile managers, was said to be planning to exit, making FrontPoint's future once again uncertain. AR