

Galleon Wiretaps Rattle Hedge Funds as Insider Trading Targeted

By Katherine Burton and David Glovin - Oct 26, 2009

Oct. 26 (Bloomberg) -- First came the biggest [bear market](#) since the 1930s, then [Bernard Madoff's](#) \$65 billion Ponzi scheme and the threat of increased regulation. Now hedge funds have a new concern: getting caught on tape as the government expands its use of wiretaps to ferret out insider trading.

Prosecutors, using secretly recorded phone conversations for the first time against hedge funds, alleged Oct. 16 that billionaire [Raj Rajaratnam](#) and five others made \$20 million by swapping material inside information on companies such as Hilton Hotels Corp. and [Google Inc.](#) They may charge at least 10 more people soon, people familiar with the matter said last week.

Rajaratnam, founder of New York-based Galleon Group LLC, regularly talked to hundreds of contacts, including other traders, according to people who know him. His arrest rattled hedge-fund managers, who are questioning whether legitimate discussions caught on the tapped lines will draw scrutiny, say lawyers who've fielded such queries. A broader worry: whose phones are being monitored as prosecutors and [U.S. Securities and Exchange Commission](#) continue their probes?

"The word wiretap strikes fear in the hearts of everyone, even the innocent," said [Brad Balter](#), who runs Balter Capital Management LLC, a Boston-based firm that allocates clients' money to hedge funds.

[Ross Intelisano](#), an attorney with Rich & Intelisano LLP in New York, said he received a call from an executive at a \$1 billion hedge fund who was considering hiring a company to test his firm's phones for listening devices. The client asked what to do if the firm found any. "Do we go to the police?" the executive asked, according to Intelisano.

The executive instructed his colleagues to be extra careful about what they say on the phone, not because they are breaking the law, but because they are fearful that any conversation about stocks could be misconstrued, Intelisano said.

Calls Aren't Safe

“After the Bear Stearns case, e-mails aren't safe, and now phone calls aren't safe,” Intelisano said. “From now on, people are going to be meeting for lunch.”

Prosecutors used e-mails to build their case against former Bear Stearns Cos. hedge-fund managers [Ralph Cioffi](#) and [Matthew Tannin](#), who are currently on trial in Brooklyn for misleading investors about the health of two funds that collapsed in 2007. It's the biggest trial stemming from a U.S. probe of banks and mortgage firms whose losses in subprime loans and related securities total at least \$396 billion.

For hedge-fund managers whose knowledge of wiretaps may have been limited to “[The Wire](#),” the HBO drama in which Baltimore police eavesdrop on drug dealers, electronic bugging is a new reality of their industry as U.S. Attorney Preet Bharara's new Complex Frauds Unit targets white-collar crime.

Covering Tracks

Prosecutors said they turned to wiretaps because of the ease with which hedge funds can hide when trades were based on illegal tips. At a bail hearing on Oct. 16, Assistant U.S. Attorney [Josh Klein](#) told a judge that Rajaratnam instructed others to fabricate “e-mail trails” that would explain why they executed corrupt trades.

“There were consistent endeavors to mask” the trades, Klein said in court.

The case against Rajaratnam, 52, who said last week he is innocent, is the largest since takeover investor [Ivan Boesky](#) and investment banker [Dennis Levine](#) were convicted in a crackdown two decades ago. Thirteen people were criminally charged in a series of schemes that investigators said stretched over five years, yielded \$15 million in illegal profits and also involved employees at UBS AG and Bank of America Corp.

Cooperating Witness

Rajaratnam allegedly obtained nonpublic corporate information from a ring that included a cooperating witness. That witness was identified by a person familiar with the investigation as [Roomy Khan](#), 50, who worked for Galleon in the late 1990s. Khan couldn't be reached for comment.

The other defendants are [Rajiv Goel](#), who worked at Intel Capital as a director in strategic

investments; Anil Kumar, who worked as a director at McKinsey & Co.; International Business Machines Corp. executive [Robert Moffat](#); [Mark Kurland](#), co-founder of New Castle Funds LLC, a former Bear Stearns Cos. hedge fund; and [Danielle Chiesi](#), a former consultant at New Castle. Their attorneys have said their clients aren't guilty.

Quadrum Capital Management LLC, a New York-based hedge-fund firm started by [Richard Grodin](#), has been subpoenaed as part of the investigation, according to a person familiar with the matter, who asked not to be identified because the information is private. Grodin, a former portfolio manager at [Steven Cohen's](#) SAC Capital Advisors LP, declined to comment.

The subpoena, reported Oct. 24 by the Wall Street Journal, is a request for information and doesn't imply wrongdoing on the part of Grodin or Stamford, Connecticut-based SAC. Before Quadrum, Grodin founded Stratix Asset Management. Cho Beng Lee, identified by the Wall Street Journal as a cooperating witness in the Galleon case, worked at Stratix as well as SAC. Lee and Grodin left SAC in early 2004, according to [Jonathan Gasthalter](#), a spokesman for SAC.

Industry Recovery

The \$1.4 trillion hedge-fund industry is recovering after posting a record loss averaging 19 percent in 2008, according to data compiled by Hedge Fund Research Inc. Funds have returned 17 percent this year, the Chicago-based firm's data show.

Confidence in the industry was shaken by the December arrest and subsequent conviction of Madoff, who victimized hedge funds and individual investors and whose fraud triggered renewed efforts by Congress and the SEC to regulate the private investment partnerships.

'Substantial Resources'

Former federal prosecutor [Steven Peikin](#), who headed the securities fraud unit in the U.S. Attorney's Office in the Southern District of New York, said investigators have long relied on advanced techniques in battling white-collar crime. What's new is the focus on hedge funds and the use of labor-intensive phone taps, he said in an interview. Last year, 84 percent of the 1,891 authorized taps were used in drug-related cases, according to a report by the [Administrative Office of U.S. Courts](#), which provides support to the federal judicial branch.

"It's a declaration that they want to submit substantial resources to this," Peikin, now an attorney at Sullivan & Cromwell LLP in New York, said of the use of wiretaps. "Preet is continuing a long and proud tradition."

Wiretaps conducted in 2008 intercepted an average of 2,707 conversations, according to the 2009 report from the U.S. courts office. Those conversations involved an average of 92 people. About one in five were incriminating.

Agents monitoring the calls are supposed to make an effort to listen and record only conversations that are related to the criminal conduct, said Eugene O'Donnell, a law professor at the City University of New York's [John Jay College of Criminal Justice](#).

Stop Listening

If the subjects start talking about unrelated topics, agents are supposed to stop listening, though they will check back every few minutes, said O'Donnell, who is a former state prosecutor and has worked with wiretaps.

"In this type of investigation the lines won't be easy to discern," between criminal and innocent conversations, he said, since much of the talk will involve company news and opinions on stocks.

Rajaratnam's phones were tapped starting in March 2008. Over time, O'Donnell said the agents probably reduced the number of conversations they recorded once they determined that certain people weren't party to the alleged crime.

Hedge-fund managers won't have to wonder forever whether they've been captured on tape, lawyers said. Once the wiretap is completed, those who were recorded and aren't targets of an investigation are notified by mail. Suspects may get a visit from federal agents.

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