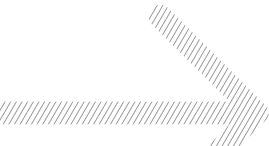


Looking for trouble

Sophisticated software is a first line of defense on the insider trading front

/ By Irwin Speizer



The largest insider trading case in hedge fund history, against Galleon Group and others, has unleashed a flurry of self-examination at other hedge funds eager to make sure they're not going to find themselves facing similar charges. Although insider trading policies and procedures can vary widely among hedge funds, one common denominator is the increased use of technology to help police trading and hunt for potential problems or rogue traders.

Since the Galleon case broke in October, providers of compliance software that includes modules to monitor transactions and help guard against insider trading problems have seen a dramatic rise in interest from hedge fund managers. At SunGard, a financial services software firm in Wayne, Pa., senior vice president Chris Aronis says sales associates for the firm's Protegent financial compliance software—who used to spend much of their time making cold calls to hedge funds—are now fielding as many incoming calls as they're dialing out.

To meet the new demand, Aronis says SunGard has been expanding the scope of its insider trading software to enable fund compliance officers to collect more data, allowing for discovery of any unusual trading in a particular security and to search more thoroughly for what may be unusually fortuitous timing of trades, which may signal possible use of inside information.

"Secrecy is the foundation of the entire industry," says Aronis. "When you look at operating behind closed doors, inherently it creates opportunities for insider trading."

The stakes are high because hedge fund managers accused of crimes may be innocent until proven guilty in the eyes of the law, but not in the eyes of investors, who

often flee at the first sign of trouble. "The impact of going over the line is that you can go out of business," says Larry Goldfarb, a cofounder of Compliance11, a Chicago trading software company.

Although Galleon founder Raj Rajaratnam has denied any wrongdoing, within days of the Securities and Exchange Commission allegations of insider trading, Galleon, which had about \$3.7 billion in assets as of July 1, according to the AR mid-year survey, was hit with a flurry of redemptions and began winding down its operations.

The SEC has made clear its intent to focus on hedge funds in its assault on insider trading. In the press conference at which the initial Galleon charges were announced, SEC enforcement director Robert Khuzami said, "It would be wise for investment advisors and corporate executives to closely look at today's case, their own internal operations and the increasing focus and scrutiny on hedge fund trading activity by the SEC and others."

One hedge fund compliance officer, who spoke on condition of anonymity, recounted how he immediately ran an e-mail trace of everyone at his firm searching for communications with any of those named in the case. He was relieved when he got no hits. But he pointed out that he, like other compliance officers he knows,

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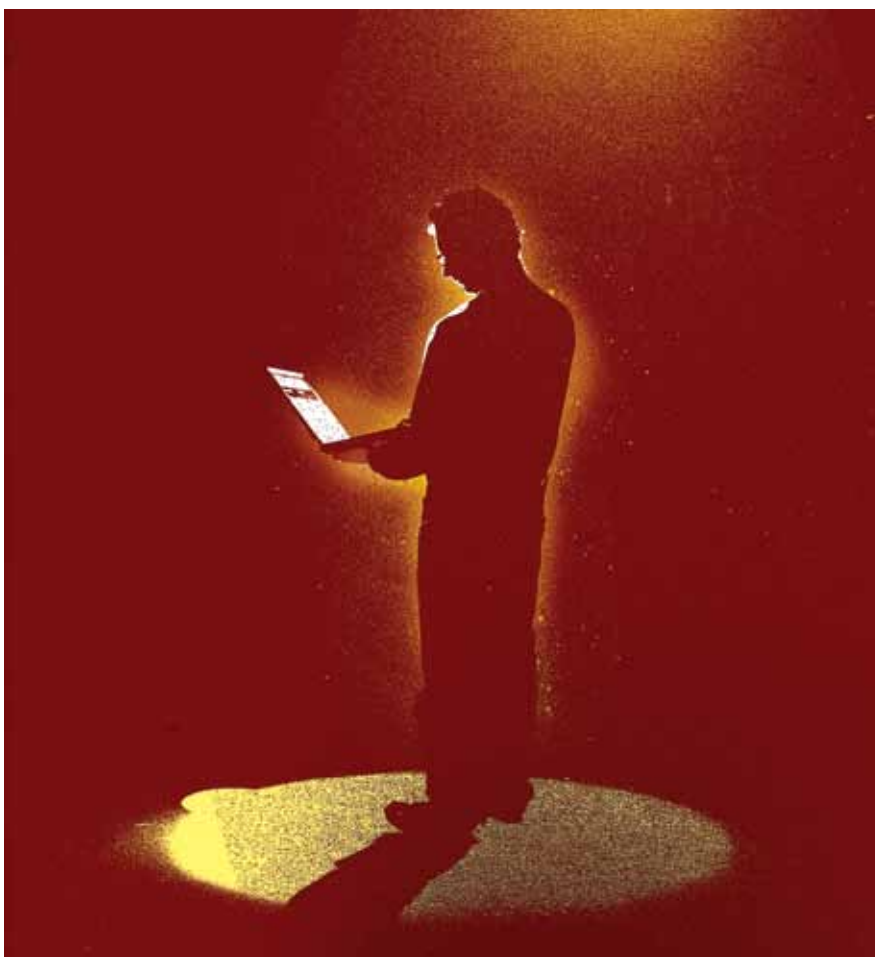
was reviewing internal insider trader policies and safeguards in light of the case.

Proactive compliance efforts can take some of the sting out of insider trading allegations. Michael Lowman, a partner in Jenner & Block in Washington, D. C., and a former SEC litigator and investigator, notes that even if the safeguards failed to thwart insider trading, "one of the things the Commission will look at is: Did you have policies and procedures in place? Did you follow them? Did you have the right training? Did you have the right monitoring? Were there red flags that you should have seen?"

Smaller funds and those with strategies not directly tied to individual security price movements, such as quant funds or managed futures strategies, often get by with very basic trading compliance policies and procedures. For funds more deeply involved in selecting and trading public securities, more robust methods are often employed to monitor trading and ensure compliance with policies and regulations. Compliance software has become increasingly important in that effort.

The software comes into play in two areas. The first is trading in company accounts. Compliance systems can be set up to screen trades beforehand for possible conflicts and also to review trades later to check for patterns that might raise suspicion. For example, securities in which the hedge fund or its members may have known conflicts—a separate business relationship with someone at the other company, perhaps, or a spouse who works at the company—can be flagged so that any attempt to trade those securities would require review and permission before being executed. Reports of gifts and entertainment expenses can also be flagged for review if any trades match up with companies providing favors.

The second area is in personal trades by members of a fund. Funds can require partners of staff members to divulge all personal trading accounts and to report trades. One role of software is to keep a digital record of disclosures by fund personnel in which they agree to report all outside trading accounts. The software can be used to track trades that



have been made in those personal accounts, allowing compliance officers to search for suspicious patterns or connections. Restricted securities can be flagged for review in personal accounts. In addition, personal trading can be monitored to ensure that individuals are not trying to profit by trading ahead of fund trades.

Compliance11, for example, offers a trading compliance suite that centralizes transaction monitoring for both fund trades and employees' personal accounts. Dutch firm Wolters Kluwer Financial Services offers a trade surveillance software package that can produce more than 40 separate reports on everything from violations of restricted trading lists to client gift and entertainment expenses.

"There is so much data that needs to be looked at," says Carol Beckett, manager of compliance surveillance technology at Wolters Kluwer. "There is trading data for the firm, employee personal trading, brokerage data. If you have to do it manually, it is literally almost impossible to keep up."

The more sophisticated software products can automate much of that process and also give compliance managers extra tools to track and analyze employee trad-

ing patterns. Systems can be set up to automatically receive trade information from brokers. Software can also be used to ensure that employees are informed and reminded of policies and rules.

At Compliance11, company policies and procedures about insider trading can be programmed into the system and used to track employee adherence to those policies. The system can also be set to send employees periodic reminders of the rules and require them to acknowledge having received the notices.

"It is a complex problem to make sure people are doing what they are supposed to be doing," says Compliance11's Goldfarb. "You have to make sure people understand the procedures. You have to create preventive measures. The key is having the tools to help you do this."

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In congressional testimony last March, SEC commissioner Elisse Walter said the agency is working on its own high-tech approaches to sniffing out patterns of illegal trading. Hedge fund managers say the heightened SEC effort is likely to push them to deploy more of their own software tools to ensure that they detect problematic transactions before the SEC does. In some cases, managers have been trying to determine whether they are themselves being bugged by the SEC.

Murray Associates, an Oldwick, N.J., firm specializing in preventing electronic snooping, received phone calls from three hedge funds asking if security sweeps could detect government phone taps. Company president Kevin Murray says he can offer no help there. These days government wiretaps are done at the phone company, not inside a suspect's home or office.

Still, a fund that can demonstrate a serious effort at policing its trading practices might have a better chance of surviving an SEC probe, says Lowman, the Washington attorney: "If you get a knock on door and it is the SEC, it will help protect the fund if you can say, 'We not only upgraded technology, but we sat down with counsel; we developed policies and procedures; we tried.' That can help you in the long run."

Compliance consultants say that effective measures to combat insider trading involve not just software but also policies, procedures and people willing to deal with potential problems. Ultimately, trading software still requires a sure hand at the controls. "A computer can gather the data," says Beckett. "It can get you a ton of information that is extremely valuable. But at some point, you need to have a person look at it and say, 'This is suspicious.'"

However, even the most sophisticated software and most diligent managers can be hoodwinked by especially sneaky rogue traders who might set up secret accounts in the name of friends or relatives to execute insider trades. And there is little that software can do to stop a corrupt head manager who chooses to override red flags and make insider trades.

Says SunGard's Aronis: "I would love to say there is a silver bullet that can protect a fund and its investors. There isn't." **AR**