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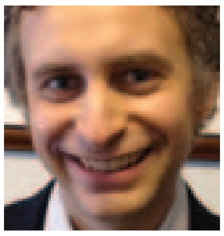

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Insider trading and the world of private funds

I recently attended the International Bar Association's 13th Annual International Conference on Private Investment Funds in London. I was interested in gauging the private investment community's response to the political and regulatory spotlight shining on both hedge funds and private equity funds. For the most part, the conference participants confirmed that, since 2008, private investment funds, which may have flown under the radar only a few short years ago, are now finding themselves in the cross-hairs of federal and international regulators. Just last year, the United States Attorney's Office successfully prosecuted Raj Rajaratnam for insider trading, underscoring the fact the criminal prosecution of hedge funds and their principals makes for international front page news. And, if press reports are to be believed, dozens more insider trading charges relating to private investment funds are still to come. So, what does this heightened regulatory environment mean for private investment funds?

Increased investor involvement
Private funds have had to learn to deal with heightened investor due diligence. Given investors' desire to avoid associating themselves with funds that end up targeted by regulators, now, more than any other time, investors have asked for – and received – access to pick apart the books and records of private investments funds. This diligence includes not only a top-to-bottom review of a fund's holdings, but in many cases, in-depth analysis of the valuation of the assets.

Ensuring regulators understand a private investment fund's trading strategy
Now US- and foreign-based regulators are focusing on private investment funds, those funds must ensure regulators understand the nature of the trading strategy during the course of an investigation. Private investment funds typically engage in complex investment strategies that, while perfectly legal, may not be straightforward, especially to a regulator who has not had extensive experience with a particular strategy. Private funds should be at the ready to explain, in detail, their strategies and valuation methods in order to beat back preconceived notions of regulators regarding the propriety of a fund's investment approach.

"Private investment funds typically engage in complex investment strategies that, while perfectly legal, may not be straightforward to a regulator"

The rise of the UK's Financial Services Authority in enforcement on insider trading
To the extent private investment funds believed international securities authorities were not as vigilant about investigating insider trading as US-based regulators, the FSA's recent fining of David Einhorn and his firm Greenlight Capital suggests otherwise. In that case, the FSA levied significant fines against Einhorn and his firm for trading shares of a UK corporation on the basis of what the FSA believed was non-public information.

Increased monitoring of communications
Given the significant role emails and instant messages have had in the latest round of insider trading investigations and prosecutions, in-house compliance units have begun monitoring employee communications in an attempt to identify improper or illicit trading.

While attorneys may not be able to foresee every regulatory issue, as more eyes are scrutinising these investments, the era in which private funds could fly under the radar is over.