

**IPPFA MIDWEST PENSION  
CONFERENCE**



***More Bad Corporate Behavior  
What's a Fiduciary to do?***



**By  
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**October 2, 2013**

**Lake Geneva, WI**



# Recent Scandals



Corporate wrongdoing which has affected your funds' investments:

- Stock option backdating by Executives
- Mutual fund market timing and late trading
- Madoff Ponzi scheme
- Financial market/banking industry meltdown caused by toxic mortgages
- Insider trading

# Here We Go Again?

- At 2011 IPPFA Conference:



GALLEONgroup

- A **seven year-long** insider trading conspiracy, the **biggest hedge fund insider case** ever, which had been in the news: The Galleon Group Scandal.
- Galleon was a huge hedge fund that had **\$7 billion** under management.
- **Raj Rajaratnam**, Galleon's Founder and Chief, was tried for insider trading, found guilty, fined **\$156 million** and sentenced to **11** years in prison.
- **60+** other people pled or were found guilty of various securities fraud and insider trading violations.



# Here We Go Again?



- ◆ The Government's investigation of Galleon has now led to the criminal indictment of an even bigger fish: **SAC Capital**.
- ◆ SAC is a **\$14 billion** hedge fund, nearly twice the size of Galleon.
- ◆ Its founder - **Steven A. Cohen** ("SAC") – is a Wall Street legend.

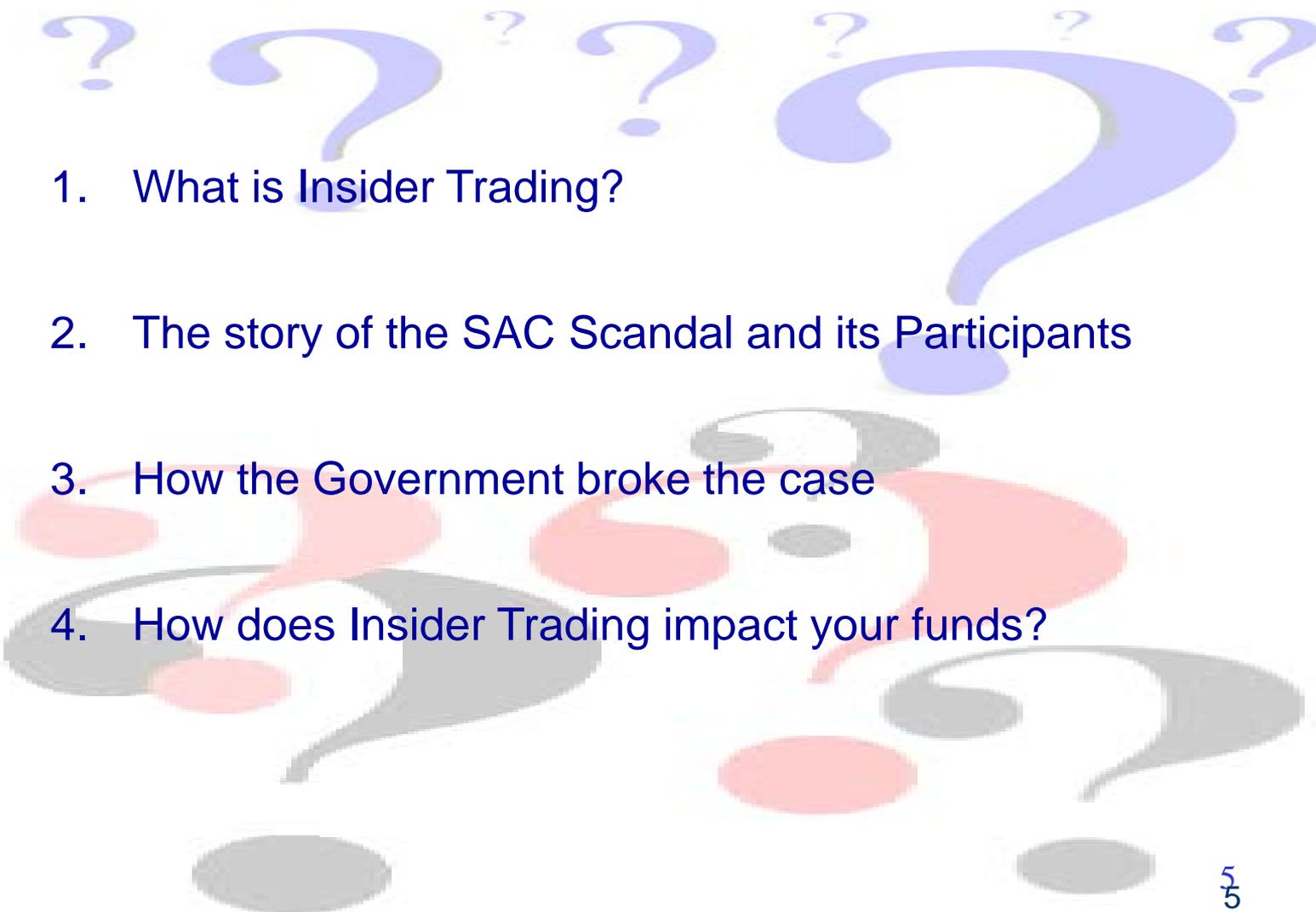
# The SAC Capital Advisors Insider Trading Scandal

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**by: Chet B. Waldman**

# The SAC Capital Trading Scandal

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1. What is Insider Trading?
  2. The story of the SAC Scandal and its Participants
  3. How the Government broke the case
  4. How does Insider Trading impact your funds?

# What is Insider Trading?



Insider Trading is:

- Trading of corporate stock, bonds, or options by individuals with access to “**non- public**” information about a company (inside information) for their **personal gain**.
- It occurs when a person knows of material confidential information about a company and then buys/sells the stock of that company or tips off others **before** the **information** is released to the **public**.
- Inside information may include confidential information of: a company takeover, accounting problems, new products, better or worse earnings than expected, etc.

# Insider Trading



- Insider trading is illegal and is “considered a securities fraud.” It may also constitute mail and wire fraud, tax evasion and obstruction of justice (*i.e.* cover-up attempts).
- It destroys confidence in the “fairness” of the capital markets and in the integrity of the marketplace.

# SAC's Founder: "Stevie" Cohen

## *The Early Years*



- ◆ Middle-class kid from Long Island, N.Y.
  - 1 of 8 children
  - Father – a garment manufacturer
  - Mother – a piano teacher
  
- ◆ Had a passion for Poker
  - In 11<sup>th</sup> grade was making \$500-\$1,000 most nights leading him to quit his summer job.
  - Went to U. of Penn. where he says he was more of a card shark than a student.
  - He has stated that he played poker, not for the money, but for the adrenaline, competition, weighing of risks and probabilities.



# Stevie Cohen: The Legend Begins

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0.66 YA 4.25 -0.20 GYG 10.14 -0.43
104.52 0.03 SIW 3.29 0.27 BO 10.54
-0.83 CKZ 82.99 0.08 LIY 76.25 -
1.07 ULR 26.85 1.13 GOOB 10.05 -1.
.36 0.66 AV 20.26 -1.38 DLI 23.29
3.85 -0.67 AY 23.29 0.87 CKZ 82.99
.45 -1.31 AYK 23.22 0.21 AO 7.53 -0
BS 5.24 -0.33 PDK 44.07 -0.24 HT
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- During his freshman year at U. of Pennsylvania, tired of attending classes, he began to spend days in Philadelphia outside a Merrill Lynch office watching stock ticker numbers go across the screen.
- He became good at guessing which way those numbers would go.
- In 1978, he graduated from college and went to work at Gruntal & Co., a small, century-old brokerage firm.
- He began a career on Wall Street as a “tape reader,” a trader who bets on stocks based on his intuitive reading on the movements of numbers.
- His very first day at Gruntal he made \$10,000 for the firm trading.
- Gruntal let its traders keep 60% of what they made for the firm.
  - The first year Cohen traded on his own he made \$100,000
  - The second year - \$1 million
  - By his **mid-20's** he was making **\$5 million-\$10 million** per year.

# SAC is Born



- Frustrated that Senior Execs at Gruntal limited his trading capital to \$50 million, by age 35, Cohen wanted to move on.
- Cohen learned about the hedge fund world from a caller who was asking for a reference about a job applicant who had worked for him. Afterwards, he left Gruntal and opened up SAC in 1992.
- SAC started with **\$25 million** in capital, roughly half was his own money.
  - Year 1: **51%** return
  - SAC charged 50% of all investment profits and a 3% management fee, while other hedge funds charged 20% of profits and a 2% management fee, but due to huge returns investors started to flock to SAC
  - By 1995, SAC assets had almost quadrupled

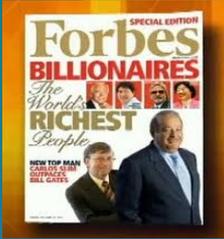
# SAC's Growth and Success Explodes



- In the second half of the 1990s, riding the wave of technology stocks, SAC's size and reputation grew further.
  - SAC became known as a voracious gatherer of market information
  - SAC traded extraordinary volumes of stock: 20 million shares a day. Up to **3%** of all stock moved on NYSE at peak
  - In 1999, SAC's largest fund posted a **69.7%** return! Overall, in 1998-2000 SAC posted **70%** annual returns!
  - Money poured in (\$14 billion by 2012).
- In 2000, Business Week crowned Cohen "The Most Powerful Trader on Wall Street You've Never Heard Of."
- Overall, SAC has generated average annualized returns of **25%**, far more than other hedge funds.



# SAC's Success Makes Stevie Cohen A Wealthy Man *How Wealthy?*



- ◆ Personally worth over **\$10 billion!**
- ◆ Lives in the largest mansion (30 rooms) in Greenwich, Ct. – a community of mansions.
- ◆ Has a huge (10,000 sq. ft.) mansion in the Hamptons (has tens of millions of dollars invested in Real Estate).
- ◆ Unsuccessfully tried to acquire the L.A. Dodgers; settled for a minority stake in the N.Y. Mets.



# The Art of Being Wealthy



- ◆ Cohen has assembled one of the greatest art collections in America – more than 300 paintings, as well as huge sculptures.



- ◆ Collection includes paintings from:
  - Picasso
  - Cézanne
  - Monet
  - Van Gogh
  - Andy Warhol
  - Jeff Koons



- ◆ His art collection is reportedly worth in the range of **\$1 billion**.

# How did SAC and Cohen Become So Successful?



- ◆ Some have called Steve Cohen the most brilliant trader of his generation.
- ◆ SAC has hired 100 or so portfolio managers each with 2-3 analysts (a “Pod”) all with strong pedigrees (Harvard, Stanford PHDs) who either perform or are fired.
- ◆ However, for many years the perception was SAC was doing something illegal to make such astounding returns: insider trading.



Harvard  
University

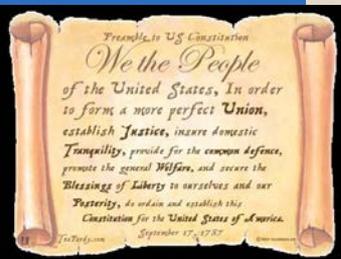


STANFORD  
UNIVERSITY

# Rumors of Insider Trading



- ◆ SAC has long had a reputation for pressing Wall Street sources for intelligence (e.g. advanced notice of analyst recommendations), perhaps crossing the legal line.
- ◆ By 2000, SAC was spending as much as **\$150 million** in commissions to Wall Street firms like JP Morgan Chase & Co. and Jefferies & Co., making it one of the Street's **top 10 customers**. More recently, that number has been estimated at more than **\$300 million**, the largest payer of fees on Wall St.
- ◆ Analysts and others at Wall St. firms would ingratiate themselves to SAC by phoning in tips of information.
- ◆ Despite rumors, neither SAC nor Cohen had ever been charged with unlawful conduct. However, it recently came out that at a deposition in a pre-SAC **1986 insider trading probe**, Cohen refused to testify, instead asserting his **5<sup>th</sup> Amendment** rights not to incriminate himself.



# The Government Investigation of SAC Begins



- ◆ In **August 2006**, a lawyer named **John Moon** walked into the SEC's N.Y. regional office with suspicions that one of his smallest clients – a fund called **Sedna Capital Management**, which had doubled its \$2 million in capital with barely a handful of trades – may have been engaged in unlawful activities.
- ◆ The SEC quickly learned that Sedna Capital was run by the brother of Raj Rajaratnam, the billionaire founder of the Galleon Group.
- ◆ Prosecutors came to discover that Raj Rajaratnam sat at the center of a vast insider trading network that was **global** in scope. They largely discovered this by **wiretapping** “little fish” who were swapping inside information with bigger fish.
- ◆ During 2008, names of former SAC traders began appearing on government wiretaps.
- ◆ When confronted with evidence of their insider trading, many of these former SAC traders agreed to cooperate with the government and themselves wore wires. They also “ratted” on some of their SAC colleagues who still worked there.
- ◆ Others on Wall St. who had provided insider info to SAC employees and got caught also agreed to testify.



# Suspicious Trading in Elan and Wyeth



- ◆ In the Fall 2008, the regulators for the NYSE noticed suspicious trading leading up to an announcement of the **clinical trial results** of an experimental drug for treating Alzheimer's called bapineuzumab or "**bapi**" being co-developed by two publicly-traded companies: Elan and Wyeth.
- ◆ The suspicious trading came from SAC. The SEC learned this from the NYSE regulator and sent out **subpoenas** seeking phone records and trading data to find anyone who had an Elan connection to someone at SAC.
- ◆ The SEC found communications that had gone on between **Mathew Martoma**, who was then a SAC portfolio manager, and a **Dr. Sidney Gilman**, a neurology professor at the University of Michigan, and Chairman of the committee that was monitoring the bapi clinical trial.

# Gilman's Disclosure of Inside Information to Martoma

- ◆ After Martoma learned that drug trials to determine the efficacy of bapi were on-going, he learned the names of **20 doctors** who worked as investigators for the drug trial.
- ◆ Martoma sent an email to an **expert networking firm** – a firm that connects Wall Street money managers with industry specialists – asking to set up consultations with all 20 doctors. While most refused to meet, Martoma was ultimately able to arrange roughly **42** consultations with Dr. Gilman. SAC paid Gilman **\$108,000** for his work.
- ◆ Gilman ultimately provided Martoma with a **summary** of the **final results** of the drug trial, which were bad, **prior** to the **public announcement** of those results which ultimately caused the prices of both Elan and Wyeth to plummet (by 42% and 12%, respectively).
- ◆ After acquiring huge positions in Wyeth and Elan stock (**\$700 million** worth), SAC sold nearly all of its holdings on the **last trading day** before the public announcement on bapi leading to **\$276 million** in **profits** and **avoided losses** according to the government. The SEC has alleged this was the **largest insider trade in history**.
- ◆ Martoma received a **\$9.4 million** bonus from SAC primarily for this trade.

# Did Cohen Know About The Insider Information Concerning bapi?

- ◆ At SAC, a PM and his team (*i.e.* a “Pod”) were expected to pass their “best ideas” to Cohen. If Cohen made money off the idea in his personal account (a process known as “**centerbooking**”), the team members would receive a 4% cut.
- ◆ Martoma included Elan and Wyeth on the list of his best ideas that he submitted to Cohen and Cohen centerbooked them = he bought their stocks in the “Cohen account.”
- ◆ Almost **\$400 million** of the \$700 million worth of Elan and Wyeth stock acquired by SAC was held in the Cohen account.
- ◆ Reportedly, evidence shows that Martoma communicated directly with Cohen about the status of bapi’s clinical trials and that Cohen communicated with others that Martoma was “**closest**” to the bapi situation which can be a euphemism for having insider information.

# Gotcha!



- ◆ After being alerted to the suspicious trading and issuing subpoenas, the FBI confronted Dr. Gilman in the summer of 2012; he agreed to give testimony in exchange for not being prosecuted.
- ◆ FBI agents confronted Martoma on the front lawn of his \$1.9 million home in Boca Raton, FL. in front of his wife and 3 children. He fainted. However, upon waking he was defiant and has remained so.
- ◆ It has now been learned that Martoma had also received confidential information from a **second doctor** involved in the bapi drug trial for aid in getting additional clinical trial business.



# Insider Trading in Dell Stock

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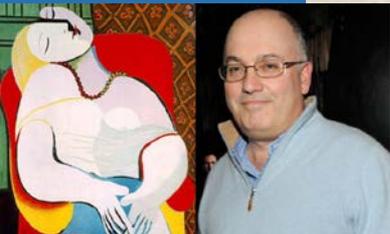


- ◆ In August 2008, Cohen allegedly sold a **\$12.5 million** stake in Dell Inc. within **10 minutes** of being forwarded an **email** in which Jon Horvath, a now former SAC trader who has pleaded guilty to insider trading, told **Michael Steinberg**, an SAC trader criminally charged with insider trading (pled not guilty), that based on a “**2<sup>nd</sup>-hand read from someone at the company,**” Dell’s earnings for the next quarter would be disappointing.
- ◆ Cohen’s lawyers have stated that he never read the email.

# The SEC Charges SAC and Cohen with Insider Trading



- ◆ The SEC commenced a **civil action** against SAC for insider trading in November 2012.
- ◆ In mid-March 2013, after years of denying its traders had violated any law, SAC agreed to pay, without admitting guilt, the **largest fine in the history of the SEC – \$616 million** – to settle charges of insider trading in only 2 trades (Wyeth/Elan and Dell).
- ◆ A week after the settlement, news broke that S. Cohen had paid casino owner Steve Wynn **\$155 million** – a **record sum** for a U.S. collector – to buy Picasso's *Le Réve* (which Wynn had accidentally put his elbow through in 2006).
- ◆ Days later, Cohen paid **\$60 million** for his 10,000 sq. ft. Hampton's house!
- ◆ 4 months later, in July 2013, Cohen was charged by the SEC in a civil case of **failing to supervise** Martoma and Steinberg. This has not been settled.



# The DOJ Brings Criminal Charges

- ◆ On July 26, 2013, the U.S. Department of Justice (DOJ) filed a **criminal indictment** against SAC, charging it with 1 count of **wire fraud** and 4 counts of **securities fraud** for illegal practices running from 1999-2010.
- ◆ The DOJ's charges portray SAC as a company in which insider trading was “**substantial, pervasive and on a scale without known precedent in the hedge fund industry.**”
- ◆ Specifically, the DOJ claims that:
  - SAC's top management ignored “**indications that trading recommendations were based on Inside Information.**”
  - Top SAC brass had a management style that tacitly **encouraged** and **rewarded** the **use of inside information.**
  - SAC looked to hire employees “**based in part on networks of contacts with employees of public companies,**” even if the prospective hire had red flags on his record.
  - SAC's compliance department and document retention policies were weak.



# The DOJ Brings Criminal Charges

- ◆ The U.S. Attorney for Manhattan stated that “**S.A.C. seeded itself with corrupt traders, empowered to engage in criminal acts by a culture that looked the other way despite red flags all around. S.A.C. deliberately encouraged the no-holds-barred pursuit of an ‘edge’ that literally carried it over the edge into corporate criminality.**”
- ◆ The criminal indictment of a **company** is very rare ever since the government’s indictment of Arthur Andersen, the accounting firm, for its role in the Enron scandal, since it put that firm out of business costing thousands of employees their jobs.
- ◆ **8** former SAC employees are mentioned in the indictment and **6** have **pled guilty** to insider trading. Martoma and Steinberg have pled not guilty and will be tried in November.
- ◆ Stevie Cohen himself, however, has **not** been indicted.
- ◆ Will Martoma or Steinberg turn on Cohen?



# Why Would Successful, Qualified People Participate in Insider Trading?

- Greed

- *E.g.*, Martoma made \$9.4 million in connection with SAC's trading in Elan and Wyeth

- Pressure to Produce: The Hedge Fund World

- In 1990 there were about **70** hedge fund firms managing **\$39 billion**
- In 2013, there are about **2,600** hedge fund firms managing **\$2.25 trillion** in assets
- **Competition** created pressure to produce **top returns**
  - **Inside information** provides the **edge** to get them
- Analysts and portfolio managers trying to keep their jobs

- Would Cohen Risk Insider Trading?

- Already a Billionaire
- Very smart
- Under scrutiny by Government for years.
- But, when faced with winning or losing on a big bet could he resist inside info.?



# How Have The Government's Actions Impacted SAC?

- ◆ Outside investors have asked for their money back. SAC is in the process of returning **\$5 billion** to those outside investors by year-end.
- ◆ One of SAC's subsidiary hedge funds was recently closed down.
- ◆ Marketing and sales staff have been let go in the last few months.
- ◆ Bright side? SAC will likely be able to **deduct** its **\$600 million SEC settlement** off its **taxes** owed, as well as its lawyers' and advisers' fees fighting the government, since it did not admit guilt.
- ◆ SAC still may stay in business because **more than \$8 billion** of its assets belong to Cohen and his employees.

# How Does Insider Trading Impact Your Funds?



1. Every time someone buys or sells shares on inside information, the **opposite side** of the **trade** is being deceived and disadvantaged.
2. *E.g.*, if your funds were **buying** Wyeth or Elan stock in 2008 because you expected bapi to be a great new drug and because you did not know that the clinical drug trials had already shown that bapi was not effective, a fact apparently known by SAC illegally, you lost money.
3. Investors also lose confidence in the stock market when they see insiders are gaming the system. **Less investors** means **less liquidity, available capital** for companies, etc.
4. Consequently, the federal securities laws allow disadvantaged shareholders harmed by insider trading to sue for their losses against the wrongdoers.
  - How do you know if your fund may have a legal claim?
    - A. **The Securities Fraud Network**

# WHAT IS THE SECURITIES FRAUD NETWORK?

- It is a **Free** Service Provided by Wolf Popper LLP for IPPFA Members; Endorsed by the IPPFA;
- Wolf Popper **Investigates Potential Legal Claims** Network Members May Have Arising Out of Securities Frauds, such as Insider Trading;
- The Network Provides Services to **Help** Your Fund **Recover Losses** From Frauds and other Corporate Wrongdoing;
- May **Litigate** on Member's Behalf on a **Contingent Fee** Basis;
- Wolf Popper Will Aid **Network** Members in Filling Out **Proof of Claim Forms**;
- Wolf Popper Advises Network Members of **Corporate Governance Matters** that May Impact the Holdings of the Securities Network Members' Funds.



# What Does Your Fund Need to Do to Join the Securities Fraud Network

- 1) **Sign the agreement** to join the IPPFA Securities Fraud Network **at no cost**. The services provided by Wolf Popper pursuant to the agreement are also **free**.
- 2) Obtain from Wolf Popper, and then **sign**, a **confidentiality agreement** which ensures that information about your fund's securities holdings remain private.
- 3) Sign the **authorization** which allows your securities custodian to give Wolf Popper the data it needs to monitor your fund's portfolio to detect corporate and accounting fraud, as well as relevant corporate governance developments.

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