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A Tale of Two Frauds: *Part I*
The SEC, Insider Trading & an "Ideal Opportunity Squandered"

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Gary J. Aguirre is a trial attorney whose practice focuses on securities regulation, securities litigation, and the representation of whistleblowers in the financial industry and regulatory agencies. After a successful career in private practice, he joined the SEC in 2004 and soon headed an insider trading investigation of Pequot Capital Management. According to a joint report of two Senate committees, the SEC fired him when his e-mail questioned the decision of his supervisory chain to give "overly deferential" treatment to an influential Wall Street banker, suspected of tipping Pequot's CEO about a pending merger. Mr. Aguirre holds a LL.B. from UC Berkeley and a LL.M. with Distinction from Georgetown Law Center in securities regulation and international law. Contact: gary@aguirrelawapc.com.

The Securities and Exchange Commission's (SEC's) ongoing crackdown on hedge funds for insider trading traces back to the U.S. Senate inquiry into the SEC's bungled investigation of Pequot Capital Management in 2006-2007. As an SEC attorney, I led the Pequot investigation until September 2005, when SEC leadership pushed it off the tracks and fired me for resisting. Later, two Senate committees concluded the SEC's mishandling of the Pequot investigation was an "ideal opportunity squandered."

The Manhattan U.S. Attorney's Office (USAO) and the FBI joined the SEC's crackdown on hedge funds in March 2007.[1] Since then, the SEC and USAO have established impressive records. The USAO claims 70 convictions without a loss since 2009. For its part, the SEC has filed approximately 40 cases for insider trading involving hedge funds since the bungled Pequot investigation became public. Before Pequot, the SEC had no system to even keep track of suspected insider trading by hedge funds, a key first step in prosecuting a mega hedge fund for the offense.

The government took off its gloves early in the crackdown. It used tactics normally reserved for investigations of drug dealers and organized crime: the FBI turned witnesses with threats of long prison terms; the USAO obtained a wiretap order in 2008 when the government's case against Galleon Group chief Raj Rajaratnam stalled.

And the SEC has become relentless in its pursuit of hedge funds suspected of insider

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trading. When neither the USAO nor SEC could make an insider trading case against Steven Cohen, the SEC sued Cohen's mega hedge fund SAC Capital and extracted $600 million through a settlement. Before the ink was dry on SAC's check, the SEC filed a "rocket docket" case—an expedited administrative proceeding with sharply limited discovery—against Cohen for failure to supervise SAC. The USAO topped the SEC last month by filing a criminal case against SAC.

But this huge commitment of resources over the past six years comes with a cost, perhaps too high. Resources are finite. Allocating those resources to insider trading cases obviously means those resources are unavailable to investigate and prosecute those responsible for the 2008 financial crisis. That crisis brought the U.S. and the world to their knees. Insider trading was not a cause of that crisis.[2]

A different kind of fraud caused the financial crisis. It was fraud on a conveyor belt. It began with the origination of mortgages: loans exceeded the value of the mortgaged properties and borrowers misstated their incomes. As mortgages moved through the securitization process, the underlying fraud got baked into the collateralized debt obligations (CDOs) that were created. Investment banks like Goldman Sachs peddled these securities with their inflated values around the world. And when the supply of mortgages ran short, the banks continued the conveyor-belt fraud, substituting synthetic CDOs. When home prices stalled, the house of cards began to collapse. As the big banks began to fail, traders accelerated their collapse with credit default swaps and naked short sales.[3] Only the infusion of trillions of dollars in Federal Reserve loans and guarantees staved off a replay of the 1929 Crash.

The costs of the financial crisis will be passed on to the next generation. The national debt increased from roughly $10 trillion in 2008 to more than $17 trillion in 2013 and is still climbing. The Fed buys $40 billion a month in agency debt, *e.g.*, Fannie Mae and Freddie Mac debt, and another $45 billion of U.S. Treasuries. Buying agency debt moves it off the banks' balance sheets and onto the collective balance sheet of U.S. taxpayers. Buying both Treasuries and agency debt holds down interest rates. Should those rates revert back to the historical norm, around 5%,[4] the value of these bonds will plunge and so will the asset side of the Fed's balance sheet. This scenario recently prompted *Forbes* to propose a stress test for the Fed.[5]

And then there is the risk Wall Street banks will engineer yet another crisis which combines high leverage with some new species of fraud, as the banks did in 2008 and 1929. The banks have become more emboldened by their ability to elude prosecution for their successive frauds. No banker went to jail for the Enron fraud, though the banks were willing participants in it.[6] They then went back to the drafting table and designed a more ambitious scam, the conveyor-belt fraud that delivered the financial crisis. Giving them another free pass invites them to design an even more ambitious fraud.

To sum up, the government's crackdown message is clear: engage in insider trading, go to jail. No comparable message has been given to those responsible for the financial crisis. The risk posed by the financial crisis to the integrity of the capital markets dwarfs any risk ever posed by insider trading. The government's failure to prosecute the culprits who created the conveyor-belt fraud serves as a seductive invitation for them to perform an encore. The Fed is still infusing a trillion dollars a year into the economy to keep it afloat. It is open for debate whether the country could tolerate a second Wall Street financial crisis.

The government's priorities are puzzling: unlimited resources dedicated to prosecute a non-cause of the crisis; yet, it watches idly as the Wall Street executives who delivered the crisis walk away with their millions of dollars in salaries and bonuses. Early on, the government claimed the financial crisis prosecutions were too hard to prove.[7] This is unintended irony. The SEC previously defended their failure to bring insider trading cases against hedge funds on exactly the same rationale: too hard to prove.[8]

The government's unrelenting prosecution of hedge funds for insider trading is a stunning reversal from its blissful indifference to the same crime

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seven years ago. What caused the change? In a word: Pequot. The SEC began to radically change its policy for handling suspected insider trading by hedge funds in December 2006. That was midway through a thrashing the SEC was taking from two Senate committees over its mishandling of the Pequot investigation. But the crackdown may now be doing more harm than good. Perhaps intended, perhaps not, the crackdown has distracted the media and the public from the government's failure to prosecute those responsible for causing the financial crisis.

This is the first of two articles that will delve into the imbalance between the government's intense prosecution of hedge funds for insider trading, a form of market abuse that undermines investor confidence, and its relatively meager prosecution of those responsible for the financial crisis, which nearly caused a global meltdown. This article will focus on the catalyst which triggered the crackdown on insider trading. The second article, scheduled for the October issue of *Wall Street Lawyer*, will discuss the government's anomalous failure to vigorously prosecute those responsible for creating or deepening the financial crisis.

The SEC's Meager Track Record before It Bungled Pequot

By 2004, the SEC was receiving a constant flow of referrals from self-regulatory organizations (SROs) of suspected insider trading by three mega hedge funds, Pequot, managed by Arthur Samberg, SAC Capital, managed by Steven Cohen, and Galleon, managed by Rajaratnam. It would be many years later before any of these hedge funds or their CEOs would be held accountable. The first to go down would be Samberg and Pequot in May 2010.[9] As odd as it seems, neither the SEC nor the Department of Justice (DOJ) could take credit for tracking down the critical evidence necessary to prove the case against Samberg and his hedge fund. To the contrary, that evidence came from me, a point the SEC almost but cannot quite concede.[10]

In June 2006, I testified before the Senate Judiciary Committee that the flow of SRO referrals should have alerted the SEC in 2004 to the rapid growth of insider trading by mega hedge funds:

> **[The SEC] receives a constant flow of suspected insider trading referrals from SROs. The NASD, NYSE, and AMEX all have market surveillance units that track the market daily for suspicious trades, including insider trading. When their computers detect suspicious trading, the SRO's staff does its own review and, if the trading appears suspicious, refers the matter to the SEC. Many of those referrals involve hedge funds suspected of insider trading (citations omitted).[11]**

I also told the Committee the referral system had broken down:

> **But that system breaks down when it comes to referrals involving insider trading by hedge funds. Those referrals are rarely, if ever, investigated, unless they happen to meet the [Private Investment in Public Equity] PIPEs cookie cutter mold. The investigation I conducted was an anomaly. The right person at intake found the right senior SEC official. That matter was assigned to me. I then found 13 other insider trading referrals on the same hedge fund that had been gathering dust. None had been investigated other than a cursory review. No one had looked at the referrals collectively for any patterns.[12]**

I testified before the Judiciary Committee in December 2006 that NYSE market surveillance staff had informed me of the identity of three hedge funds that were repeatedly the subjects of insider trading referrals to the SEC and one of them was Pequot.[13] The government and the media have now identified the other two as SAC and Galleon.

Before the SEC's bungling of the Pequot case became public, the SEC's track record in bringing cases against hedge funds for insider trading was close to nonexistent. I chronicled that track record in my December 2006 Senate testimony.[14] The SEC had never brought an insider trading case against a large hedge fund. It had brought only six cases against hedge funds of any size for insider

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trading since hedge funds first appeared on the financial landscape 57 years earlier. The SEC used the same cookie cutter approach in three cases:[15] a hedge fund learned of a PIPEs offering from a confidential source, shorted the stock, and then covered it after the announcement. The SEC's allocation of resources to PIPE insider trading cases was puzzling. The PIPE market was tiny: $20 billion in 2005. By comparison, the value of mergers and acquisitions that year was $1.46 trillion.

Before the Pequot investigation became public, aside from the PIPE cases, the SEC had brought only three cases against hedge funds or their principals *for all other types of insider trading—SEC v. Kornman*,[16] *SEC v. Tom*[17] and *SEC v. Obus*.[18] In two of those cases, *Kornman* and *Tom*, the SEC sued the principals of two tiny hedge funds, essentially boiler-room operations, which vanished without a trace after the complaints were filed. In *Obus*, the SEC sued a mid-sized hedge fund, its principal and two others. It recovered nothing.[19] The DOJ's record for prosecuting hedge funds was worse.[20] The meager government prosecution of hedge funds before Pequot would hardly deter the mega hedge funds—Pequot, SAC and Galleon—which appeared to routinely engage in insider trading. To the contrary, it was an invitation to stuff their pockets; the government wasn't looking.

How the SEC Bungled Pequot

On August 3, 2007, the Senate Finance and Judiciary Committees issued a joint report, *The Firing of an SEC Attorney and the Investigation of Pequot Capital Management*.[21] The facts stated below are largely taken from this report.

On September 7, 2004, I began as an Enforcement attorney at the SEC's headquarters in Washington, D.C. During my last eight months at the SEC, I worked on a single case—the investigation of Pequot for insider trading and market manipulation. In February 22, 2005, SEC Assistant Director Mark Kreitman set a "high priority" for Pequot: the opening of a criminal investigation by the USAO.[22]

By June 2005, I had two sets of suspected insider trading transactions by Pequot and Samberg to present to the USAO. In one set, Samberg directed purchases of Heller Financial stock and short sales of General Electric stock during the 30 days before the announcement that GE was acquiring Heller at a *50% premium to its stock price*.[23] Pequot made $18 million on the combined trades.[24] The suspected tipper was John Mack, the incoming CEO of Morgan Stanley.[25] In the second set, Samberg directed the purchase of Microsoft calls and puts—the equivalent of purchasing Microsoft stock—10 days before the announcement of Microsoft's earnings. Samberg's trades in Microsoft made Pequot $14.7 million.[26] The suspected tipper was David Zilkha, a Microsoft employee who was about to go to work for Pequot.[27]

I scheduled a meeting on the Pequot case with the USAO for mid-June 2005. The day before the meeting, Assistant Director "Kreitman asked [me] to walk him through the evidence of Pequot's suspicious trades. [I] prepared a tabbed binder with hundreds of pages of documents including both blue sheet data reflecting Pequot's trades and Samberg's e-mail exchanges."[28]

The Senate report described Kreitman's reaction to my presentation:

> **After Aguirre previewed the presentation for Kreitman, he gave Aguirre a motivational award in recognition of developing the case into a potentially criminal matter. The award was a photocopied picture of Raymond Burr, which Kreitman described as "the Big Perry" in reference to Burr's portrayal of the fictional, legendary attorney Perry Mason.[29]**

I made the same presentation the next day to the FBI and USAO. Not long afterwards, both opened criminal investigations of the GE-Heller and Microsoft trades.[30] On August 21, 2005, the SEC gave me a two-step raise for my work on Pequot.[31] Ten days later, while I was on vacation, the SEC fired me on one day's notice.[32] Fourteen months later, the SEC dropped the Pequot investigation without bringing charges against anyone.

In June 2006, in a front page article, *The New York Times* reported the Senate Finance Committee had opened an investigation into the SEC's handling of the Pequot insider trading case and

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my firing.[33] A few days later, the Senate Judiciary Committee joined the investigation. Over the next 14 months, Committees' staff reviewed 10,000 pages of documents and conducted more than 30 witness interviews.[34] The Judiciary Committee held three related hearings during 2006.[35]

At the last hearing in December 2006, the SEC took the offensive. It released the case closing report on Pequot to The Wall Street Journal the night before the hearing.[36] It told how SEC staff labored brilliantly and long, but alas the evidence was not there and thus no case would be filed against Pequot, Samberg, Mack, or Zilkha. Among the reasons the SEC gave for not filing a case: Pequot's $80 million in trades—buys on Heller, shorts on GE—during the 30 days before the announcement of the GE-Heller merger "were not atypical for Pequot." The effect might have been the same had the SEC hung a banner at the entrance to its headquarters: "Insider trading now legal for mega hedge funds." The result was predictable: insider trading referrals from SROs on mega hedge funds spiked.[37]

On January 31, 2007, the Committees' Chairmen, Sen. Charles Grassley (R-Iowa) and Sen. Arlen Specter (R/D-Pa.), entered their interim report into the Senate record, described their findings from the Senate floor, and released 1,300 pages of records. The two senators politely requested the SEC to reopen the Pequot case: "[W]e hope the SEC will consider reopening its investigation into the Pequot matter given our findings. …We urge the SEC to take Aguirre's allegations seriously and seek to improve the management and operations of the Commission based on lessons learned from this controversy."[38] The SEC did not reopen the investigation *at that time*.

Six months later, on August 3, 2007, the Committees issued their final report.[39] The findings and conclusions extended over 108 pages with 372 footnotes and more than 500 pages of exhibits and testimony excerpts. The report described the unfulfilled promise of the Pequot investigation with these words: "The investigation of Pequot Capital Management could have been an ideal opportunity for the SEC to develop expertise and visibility into the operations of a major hedge fund while deterring institutional insider trading and market manipulation through vigorous enforcement."[40] Instead, the SEC "squandered this opportunity." In the words of the Committees:

> **[T]he SEC squandered this opportunity through a series of missteps, including (1) unnecessary delays, (2) understaffing, (3) excluding many of the suspicious transactions, (4) allowing inadequate and untimely document production, (5) disclosing case information to John Mack's prospective employer, Morgan Stanley, and (6) preventing the staff from questioning Mack until after the statute of limitations had expired.[41]**

The final Senate report cited and summarized the evidence proving each misstep. Three are discussed below.

Excluding suspicious transactions: "[I]n early February 2005, …[Branch Chief Mark] Kreitman directed that the PCM [Pequot] investigation be narrowed to two or three matters [although] SROs identified between 17 and 25 sets of suspicious trading involving Pequot… The SEC did not examine most of the suspicious activity in any depth." [42]

Understaffing: "The SEC assigned only one staff attorney to the investigation full-time: Gary Aguirre… Aguirre shared one paralegal with several other staff attorneys working other cases. By contrast, one law firm [there were eight altogether] representing Pequot said it had 59 attorneys and paralegals working on the case and reviewing documents six days and 60 hours per week."[43]

Delaying Mack's testimony until the statute had run out: On cross-examination by Sen. Specter, Aguirre's supervisor, SEC Branch Chief Robert Hanson, could give no credible answer why the Mack examination had been delayed until the statute ran:

> ***Sen. Specter*****: [W]hy did you wait until after the statute of limitations had expired to take Mr. Mack's testimony?**
>
> *Mr. Hanson*: **We took Mr. Mack's testimony, as I described in my written state-**

ment, which I will ask to be made part of the record.

Sen. Specter: **But that does not tell us why you waited until after the statute of limitations had expired.**

Mr. Hanson: **We got to it as soon as we could.**[44]

A separate part of the report dealt with my firing. It quoted my immediate supervisor's official evaluation of my performance:

Gary worked extremely hard on one investigation during his time in the group, a significant matter involving the trading by Pequot Capital, one of the nation's largest hedge funds. Gary has an unmatched dedication to this case (often working well beyond normal work hours) and his efforts have uncovered evidence of potential insider trading and possible manipulative trading by the fund and its principals. He has been able to overcome a number of obstacles opposing counsel put in his path on the investigation. Gary worked closely with the Office of Compliance Inspections and Examinations to develop the case and worked with several self-regulatory organizations to develop a number of potential leads. He has consistently gone the extra mile, and then some.[45]

My supervisors would try to replace this evaluation after I sent an e-mail describing how the SEC was giving Mack, a suspected tipper, preferential treatment. My e-mail confirmed my supervisor had prohibited Mack's examination, because of his "powerful political connections." My e-mail closed: "I do not believe that treating Mack differently is consistent with the Commission's mission, at least as I understand it."[46]

Two days after this e-mail, my supervisors drafted a "re-evaluation" which was intended to lower my performance rating from "contributions of high value" to unsatisfactory.[47] The Senate committees concluded the SEC fired me "as part of a process of reprisal" which began with my "re-evaluation" two days after my e-mail questioned the preferential treatment the SEC was showering upon Mack.[48]

The committees also asked the SEC to make nine structural changes. Each proposed change correlated to an SEC misstep in handling the Pequot investigation or my firing. Distilled to their essence, the Committees asked the SEC to:

1. Develop a manual telling Enforcement staff how to conduct investigations;
2. Prioritize cases and allocate sufficient staff to the important ones;
3. Document communications with entities under investigation and discourage communications in the absence of the lead attorney;
4. Structure the SEC Inspector General's (IG's) role for greater independence;
5. Require SEC staff to recuse themselves in cases involving potential employers;
6. Create and follow standardized rules when evaluating staff's performance;
7. Protect internal whistleblowers;
8. Follow the rules when terminating employees, especially one who is heading a major investigation; and
9. Establish confidential channels for internal whistleblowers.[49]

By her letter of May 8, 2009, then-SEC Chairman Mary Schapiro informed Sen. Grassley that the recommendations had been fully implemented.[50]

Eight months after the Senate issued its final report, my Freedom of Information Act (FOIA) case against the SEC began to heat up in the U.S. District Court in Washington, D.C. Among other records, I sought the Pequot investigative files. Case law required me to show the SEC had acted illegally or improperly.

In *Aguirre v. SEC*,[51] the court granted my summary judgment motion and directed the SEC to release the Pequot investigative files to me. Adopting key findings from the Senate report, the court concluded the SEC's impropriety had been "easily established." The court reasoned:

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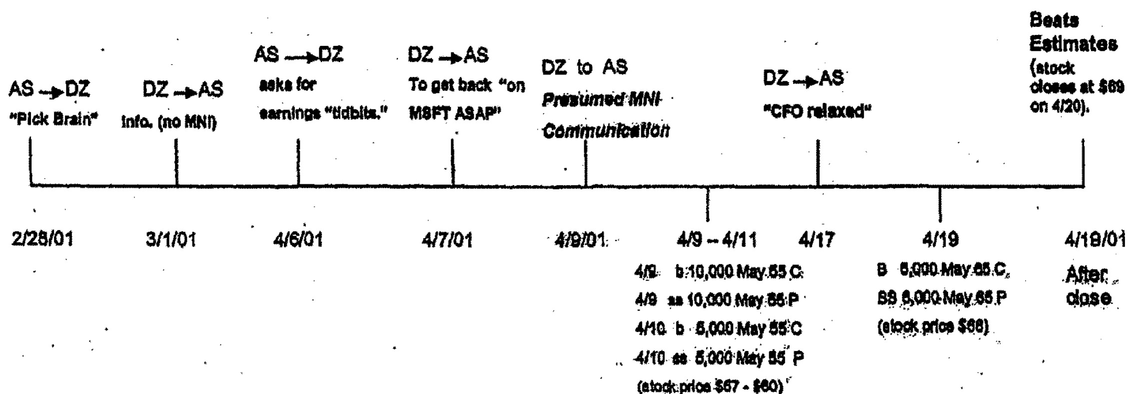
The Committees determined that SEC officials were "overly deferential" to John Mack because of his prominence. When the SEC accords special treatment to prominent figures, it "undermines public confidence [in] the integrity of its investigations and exacerbates the problems associated with 'regulatory capture.'" Second, the Committee found credible evidence suggesting that the SEC retaliated against plaintiff for his efforts to examine John Mack. SEC management conducted a suspicious "re-evaluation" of plaintiff, even though his regular evaluation had just been completed a month earlier, and according to the Senate Report, the re-evaluation "appears both improper and retaliatory," and the negative comments were "unsupported." The Committees concluded that plaintiff's firing was "intricately connected" to his efforts to examine John Mack.[52]

The dispute between me and the SEC would still wind its way through three more forums. Six months after the court decision, the SEC's new IG recommended that my supervisors be disciplined for their handling of the Pequot investigation, including then-SEC Enforcement Director Linda Chatman Thomsen for providing nonpublic information to Morgan Stanley about the Mack investigation. But the SEC rejected its own IG's report and refused to discipline them.[53] The Office of Special Counsel, after conducting its own investigation, brought a corrective action against the SEC, alleging it had violated the Whistleblower Protection Act in firing me. Finally, as *The New York Times* reported, I settled my whistleblower reprisal case against the SEC in 2010, with the agency paying "the largest [settlement] disclosed by the Merit Systems Protection Board, the federal agency that oversees such cases."[54]

But there was one more unlikely twist. By November 2008, I had received the Pequot investigative files from the SEC, including incriminating e-mails between Zilkha and Samberg on the Microsoft trades,[55] which I found in 2005 while at the SEC. I reduced the Microsoft case in 2005 to a one-page timeline, which I gave to my supervisors, the FBI and USAO.[56] [*See graphic*]

It pinpointed the key events: Samberg's April 6, 2001, e-mail to Zilkha seeking "tidbits" on Micro-



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soft's earnings;[57] Zilkha's e-mail on April 7 promising the tidbits "ASAP";[58] and Samberg's purchase of 35,000 option contracts on April 9, 10, and 11.[59] The timeline included my hunch that Zilkha had communicated the illegal tip to Samberg on April 9.[60] But there was a gap in the evidence in 2005: what exact "tidbits" did Zilkha pass to Samberg about Microsoft's earnings on April 9?

After I presented the Microsoft case to FBI agents in June 2005, they asked me not to contact Zilkha, because they wanted to arrange a surprise meeting to see if they could turn him.[61] Consequently, I took no further steps to develop the Microsoft case before my discharge.

In November 2008, two years after the SEC closed the Pequot investigation, I received an anonymous voicemail with this message: records in a divorce case in Connecticut would confirm Pequot was paying Zilkha $2.1 million in three annual installments of $700,000.[62] The first payment had been made a few months after the SEC closed the Pequot investigation.[63] I informed Senate investigators, who obtained copies of the court records.[64] Eventually, the anonymous source identified himself as Glen Kaiser, the husband of David Zilkha's ex-wife.[65]

Kaiser also informed me he was in possession of a hard drive which might contain Zilkha's e-mails for 2001.[66] I requested Kaiser to search for an e-mail between April 6 and 9, 2001.[67] On December 20, 2008, Kaiser faxed me two e-mails; one from Zilkha to a Microsoft executive, Mark Spain, asking whether Microsoft would miss earnings.[68] Spain's e-mail responded: "march was the best month of record. made up the shortfall in us sub. w2k pro major contributor. on track for revised forecast (MYR). [sic]."[69] This e-mail fit like the last piece of a picture puzzle.

My e-mails to Senate investigators, the FBI,[70] and my 16-page letter sent January 2, 2009,[71] to then-SEC Chairman Christopher Cox explained in detail how the new "smoking guns," when combined with evidence I uncovered in 2005, were sufficient to reopen civil and criminal investigations of Samberg, Pequot and Zilkha for insider trading. A comparison of my letter with the complaint the SEC would eventually file against Samberg and Pequot in 2009 demonstrates the SEC adopted the factual analysis from my January 2 letter.[72] Forbes put it this way: "After a scathing 2007 report by the Senate criticized the SEC's handling of Aguirre's Pequot investigation, and after Aguirre dredged up the smoking gun e-mails and passed them along to the Senate, the FBI and the SEC in late 2008, the SEC reopened the case in January 2009."[73] Sixteen months later, Samberg and Pequot paid the SEC $28 million to settle the Microsoft insider trading case.[74]

Curiously, after firing me, no one investigated the scenario summarized on the one-page timeline I gave my supervisors, the FBI and USAO in mid-June 2005. The timeline pinpointed the e-mails of April 6, 7, and a "Presumed MNI [material nonpublic information] Communication" from Zilkha to Samberg on April 9, 2001.[75] The SEC's case closing report on Pequot confirms SEC staff investigated Pequot and Samberg for Microsoft trades,[76] but only for communications on April 17 and 27, 2001.[77] The SEC complaint filed in 2010 tightly follows my one-page timeline created five years earlier.[78]

The Crackdown Began with the Senate Investigation of the SEC's Pequot Caper

The collision between the Senate committees and the SEC over Pequot would permanently change the landscape. Until Pequot, the 21st Century SEC viewed insider trading as one-time events, crimes of opportunity, *e.g.*, trading on a merger after a friend's tip. The SEC organized its files around these one-time events affecting public companies' stock.

The SEC's simplified view of insider trading was unshaken despite the constant flow of referrals from SROs of suspicious trading by mega hedge funds. The SEC did not detect the presence of a new species—hedge funds—which played the insider trading game differently. Hedge funds did not wait patiently for tips to fall on their laps. Like predators, they hunted them down.

I took a different approach in the Pequot investigation, focusing on patterns showing Pequot repeatedly placed timely, right bets just before public announcements of market-moving events.

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This would later be the underlying strategy in the SEC's investigation of Galleon and Rajaratnam.

But the pattern approach was not my idea. Two days after I started with the SEC, I was assigned to investigate Pequot's trading in one public company. I inquired about the SEC's tracking system so I could find prior referrals of Pequot's suspicious trading, but soon learned none existed.[79] I asked around within the SEC about prior Pequot referrals, and also e-mailed the market surveillance units of SROs inquiring about records of suspected insider trading by Pequot in other public companies. After a month, I accumulated a total of 14 SRO Pequot referrals.

Among them was one from the NYSE on Pequot's trading on GE-Heller, which had been at the SEC gathering dust for two years. Curiously, the SEC had investigated a low-level GE employee who had made $157,000 with his partner, a kung fu instructor. The GE employee served 15 months in prison for his crime.[80] But the SEC passed on the possible insider trading by Pequot and Samberg who had made $18 million on their trades.

With 14 insider sets of trades on one of the world's biggest hedge funds, I was very green and knew it. Serendipitously, the SEC held a training session on insider trading on October 7, 2004, for all incoming staff. The session was taught by Hilton Foster, a 30-year SEC veteran, who was introduced "as the most knowledgeable person on insider trading at the Commission."[81] I sought out Foster after the training session and showed him the spreadsheet of referrals. Foster told me that he considered Pequot and Samberg to be "serial insider traders." Foster had "tried to make a case against them a decade ago, but failed."[82] He agreed to help me part-time on the investigation. Foster explained to me why the 14 referrals were critical in making the Pequot case, just as he told Senate investigators 11 months later: a mega hedge fund will claim it usually trades in millions of shares and sometimes gets lucky.[83] Later, as the Senate report tells, I was instructed to cut the investigation to two or three sets of trades shortly after Pequot's lead counsel met with then-SEC Director of Enforcement Stephen M. Cutler.[84] Ultimately, only three sets of referrals would be investigated—suspected insider trading by Pequot in AstraZeneca, GE and Heller stocks, and Microsoft options. As Foster predicted, and Pequot would claim, "the size of [Pequot's] position in Heller was not atypical for Pequot."[85] The SEC accepted this explanation in closing its investigation.

In my June 2006, Senate testimony, I told the Judiciary Committee that insider trading by hedge funds was on the rise, and the United Kingdom's Financial Services Authority (FSA)[86] had reached a conclusion why this was happening:

> **There is growing evidence that today's unregulated pools—hedge funds—have advanced and refined the practice of manipulating and cheating other market participants. …This species of fraud—victimizing other market participants—also operates under the SEC's radar. … According to the FSA, "insider trading is now institutionalized" because of the flow of tips from investment banks to hedge funds. The FSA "had uncovered signs of insider dealing at almost a third of British M&A deals…"[87]**

Later that summer, *The New York Times* reported that its own study found evidence of insider trading in advance of 41% of mergers in the U.S. of more than $1 billion, a higher percentage than the FSA had found.[88]

At the December 2006, Judiciary hearing, Enforcement Director Thomsen gave a strong signal of the coming SEC crackdown. She conceded the SEC did not keep track of SRO referrals for insider trading by hedge funds. She testified: "The SEC presently does not have an electronic system to aggregate referrals based on the identities of the specific traders involved."[89] This explained why the SEC was unaware insider trading had become institutionalized; it was not watching the hedge funds. She continued: "We anticipate implementing a new case-tracking system by mid-2007."[90] This would facilitate the type of investigation that staff undertook in Pequot: focus on the pattern of big trades before the announcement of market-moving events.

This 180-degree reversal of the SEC's Enforcement policy towards insider trading by hedge funds was welcomed by Sens. Grassley and Specter. Their report tracked the new SEC resolve in

2007 to prosecute hedge funds for insider trading, and it noted that SEC leadership had declared a fundamental policy change. On March 1, 2007, Chairman Cox had stated "the SEC is targeting hedge fund insider trading as a top priority."[91] About the same time, Enforcement Director Thomsen announced "the SEC has made investigating insider trading ahead of mergers and acquisition one of its top priorities."[92] The Senate report also noted other senior SEC staff were making similar statements about the crackdown on hedge funds for insider trading.[93]

The SEC's verbal crackdown on hedge funds continued in 2007 and 2008. The SEC filed only one case against a hedge fund for insider trading in 2007[94] and another in 2008.[95] But these meager filings were more than offset by the SEC's stern warnings to hedge funds. Around September 2007, the SEC announced it had sent a 27-page letter to dozens of hedge funds seeking information about ties between hedge funds and brokerage firms and public companies. *The Guardian* quoted an SEC spokesman on the purpose of the letter: "Insider trading is a key focus of our examination program."[96] *The Guardian* also linked the letter to my testimony in 2006 that banks were giving hedge funds "tip-offs on mergers and acquisitions." In 2008, the SEC's crackdown began to look for real: the SEC announced it had issued subpoenas to more than 50 hedge fund managers.[97]

The meager SEC filings—two small cases in 2007 and 2008—implies the SEC had few investigations in the pipeline when it declared its crackdown on hedge funds for insider trading in early 2007. In fact, the insider trading investigation of Galleon, which led to the SEC and USAO complaints, began in early 2007, shortly after the last Senate Pequot hearing.[98] The SEC strategy in the Galleon investigation was exactly what Foster had proposed in Pequot—making the case with numerous, big, lucky bets shortly before public announcements. The SEC dispatched staff from the Office of Compliance, Inspections and Examinations (OCIE) to search Galleon's records for patterns of lucky trades shortly before public announcements of market-moving events.[99] OCIE found what they were looking for. The multiple, lucky trades strategy would be incorporated into the Galleon and Rajaratnam complaints. The jury would later convict Rajaratnam of insider trading on 10 sets of trades, every set submitted to it.

The SEC case filings significantly bumped up in 2009 and almost doubled in 2011. By that time, Rajaratnam had been sent to prison and Galleon had collapsed.[100] Likewise, Pequot had been charged and folded.[101] The investigation of SAC began in 2011 after Sen. Grassley, taking a page from his Pequot playbook, pressed the SEC "to explain how it handled" 65 SRO referrals on SAC.[102] The highly publicized crackdown on hedge funds for insider trading has reverberated back and forth across the country. Only a hermit trading from a cave in the Rockies would have been unaware of it.

The government's insatiable appetite for insider trading cases has found a match in the media's frenzy to cover it. Indeed, a symbiotic relationship has emerged between the two. The government files a case against a hedge fund for insider trading and the media transforms it into a "crackdown on Wall Street." None did this better than *Time* magazine with its February 13, 2012, article featuring U.S. Attorney Preet Bharara on its cover with the caption, "This Man Is Busting Wall Street." Yes, Bharara has 70 convictions for insider trading, but no cases against any executive of the Wall Street banks which brought the nation to the edge of the abyss in 2008, an abyss last visited in 1929. Whether or not the zealous prosecution of insider trading was designed to distract the media and thus the public from the government's failure to hold Wall Street accountable for the crisis, it undeniably has had that effect. Preet Bharara on *Time* magazine's cover "Busting Wall Street" is proof beyond a reasonable doubt of that fact.

Next: While the SEC Distracts, Wall Street Walks.

NOTES

1. *Memorandum Opinion and Order*, *US v. Rajaratnam et al.*, Case 1:09cr-01184-LAP,

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November 24, 2010, PACER Document No. 148, at 36-37.

2. There could be an exception to this generalization: if hedge funds purchased credit default swaps using confidential nonpublic information, a possibility government has hardly explored.
3. "Cramer described the process in which short-sellers and hedge funds targeted banks and destroyed them. By using unregulated credit default swaps, short-sellers were able to create unsubstantiated fear in a stock." Scott Rutt, Cramer's 'Mad Money' Recap: October 14, TheStreet.com, October 14, 2008.
4. "During much of the nation's history, top-grade borrowers typically paid somewhere in the range of 4%-6% for long-term money." Randall W. Forsyth, *About as Low As They'll Go: For Interest Rates, an Historic Turning Point Has Arrived*, Barron's, November 26, 2001, at 21.
5. Marc Miles, *Given Its Highly Risky Balance Sheet, It's Time to "Stress Test" the Fed*, Forbes.com, June 9, 2013; *available at* http://www.forbes.com/sites/realspin/2013/06/09/given-its-highly-risky-balance-sheet-its-time-to-stress-test-the-fed.
6. Aguirre, G.J. (2003) *The Enron Decision: Closing the Fraud-Free Zone on Errant Gate-keepers?* Delaware Journal of Corporate Law, 28:447-511.
7. Marian Wang, *Why No Financial Crisis Prosecutions? Ex-Justice Official Says It's Just Too Hard*, December 6, 2011, http://www.propublica.org/article/why-no-financial-crisis-prosecutions-official-says-its-just-too-hard.
8. "It is important to understand how difficult it is to build an insider trading case. They are unquestionably among the most difficult cases we are called upon to prove, and despite careful and time-consuming investigations, we may not be able to establish all of the facts necessary to support an insider trading charge."—Thomsen, Linda, Director, SEC Division of Enforcement, *Illegal Insider Trading: How Widespread is the Problem and is there Adequate Criminal Enforcement?* Testimony, September 26, 2006, (S. HRG. 109-806) (hereafter "S. HRG. 109-806") at 143; *available at* http://www.gpo.gov/fdsys/pkg/CHRG-109shrg31445/pdf/CHRG-109shrg31445.pdf.
9. SEC Press Release No. 2010-88, *SEC Charges Pequot Capital Management and CEO Arthur Samberg with Insider Trading*, May 27, 2010, (hereafter "SEC Press Release No. 2010-88"); *available at* http://www.sec.gov/news/press/2010/2010-88.htm.
10. The SEC concedes it obtained the evidence in January 2009 when it received the e-mails that proved the case (SEC Press Release No. 2010-88). I provided those e-mails by facsimile and Federal Express to the SEC on January 2, 2009. *See* my letter at: http://www.whistleblower.org/storage/documents/AguirreLetter.pdf.
11. Aguirre, Gary, *Hedge Funds and Independent Analysts, How Independent are Their Relationships?* Testimony, June 28, 2006, before the U.S. Senate Committee on the Judiciary (S. HRG. 109-696) (hereafter "S. HRG. 109-696") at 108; *available at* http://www.gpo.gov/fdsys/pkg/CHRG-109shrg31059/pdf/CHRG-109shrg31059.pdf.
12. S. HRG. 109-696.
13. Aguirre, Gary, *Examining Enforcement of Criminal Insider Trading and Hedge Fund Activity,* Testimony, December 5, 2006, before the U.S. Senate Committee on the Judiciary (S. HRG. 109-898) (hereafter "S. HRG. 109-898"); *available at* http://www.gpo.gov/fdsys/pkg/CHRG-109shrg35458.
14. S. HRG. 109-898 at 512-516.
15. *SEC v. Deephaven Capital Mgmt., LLC and Bruce Lieberman*, SEC Litig. Release No. 19683 2006 (May 2, 2006); *SEC v. Langley Partners, L.P., et* al. SEC Litig. Release No. 19607, (March 14, 2006); and *SEC v. Hilary L. Shane*, SEC Litig. Release No. 19227 (May 18, 2005).
16. SEC Litig. Release No. 18836 (August 18, 2004).
17. SEC Litig. Release No. 19729 (June 15, 2006).
18. SEC Litig. Release No. 19667 (April 25, 2006).
19. The text above summarizes a portion of my written testimony before the Judiciary Committee at the December 5, 2006, hearing; *supra*, n. 13.
20. The DOJ charged the principals of one tiny hedge fund with insider trading. Brett Arends, *Hedge fund owner faces charges*, Boston Herald, December 29, 2005, at 31.
21. U.S. Senate Committee on the Judiciary and US Senate Finance Committee, *The Firing of an SEC Attorney and the Investigation of Pequot Capital Management*, S. Rpt. 110-28, August 2007 (hereafter "Report") at 15; *available at* http://aguirrelawapc.com/global_pictures/Attachment_9.pdf.
22. S. HRG. 109-898 at 55.
23. Report at 15.
24. Report at 15.
25. Report at 24.
26. "As a result of illegal trading by Samberg and Pequot, the Pequot funds received gains of $14,769,960, approximately $4.1 million of which were attributable to stakes held by Pequot and Samberg in the funds and to certain performance and management fees they generated." *SEC v. Pequot Capital Management, Inc., et al.*, Case No. 3:10-cv-00831, Complaint, ¶ 2, May 27, 2010;

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available at http://www.sec.gov/litigation/complaints/2010/comp-pr2010-88.pdf.
27. Report at 38.
28. Report at 24.
29. Report at 24.
30. S. HRG. 109-898 at 550.
31. Report at 58.
32. Report at 67.
33. Walt Bogdanich and Gretchen Morgenson, *SEC Is Reported to Be Examining a Big Hedge Fund*, NY Times, June 23, 2006, at A1.
34. Report at (1).
35. S. HRG. 109-696, *supra*, n. 11; S. HRG. 109-806, *supra*, n. 8; and S. HRG. 109-898), *supra*, n. 13.
36. The case closing report was attached to the testimony of Linda Thomsen. S. HRG. 109-898 at 1276 and 1308.
37. Kara Scannell, *SEC Got 45 Tips on Pequot,* Wall St. Journal, Aug 11, 2009, at C1. Jean Eaglesham, *Referrals on SAC Disclosed,* Wall St. Journal, June 16, 2011, at C3.
38. 153 Cong. Rec. (Jan 31, 2007), *available at* http://www.gpo.gov/fdsys/pkg/CREC-2007-01-31/pdf/CREC-2007-01-31-pt1-PgS1381-2.pdf.
39. *Supra*, n. 21.
40. Report at 46.
41. Report at 46.
42. Report at 17.
43. Report at 17.
44. Report at 34, citing S. HRG. 109-898, at 29.
45. Report at 57.
46. Report at 56.
47. Report at 67.
48. Report at 81.
49. Report at (7-8).
50. *Available at* http://www.grassley.senate.gov/news/upload/Grassley-Ltr-May-8-2009-2.pdf.
51. *Aguirre v. S.E.C.,* 551 F. Supp. 2d 33, 56 (D.D.C. 2008).
52. *Aguirre v. S.E.C.,* 551 F. Supp. 2d 33, 56 (D.D.C. 2008).
53. SEC OIG, Re-*Investigation of Claims by Gary Aguirre of Preferential Treatment and Improper Termination,* Case No. OIG-431, September 30, 2008, at 187-191; *available at* http://pogoarchives.org/m/fo/sec-oig-report-20080930.pdf; Marcy Gordon, *Judge Won't Take Action against SEC Officials*, AP, November 8, 2008.
54. Gretchen Morgenson, *SEC Settles with a Former Lawyer*, NY Times, June 29, 2010, at B3.
55. S. HRG. 109-898 at 517-519.
56. S. HRG. 109-898 at 628.
57. Report at 21.
58. Report at 21.
59. Report at 21, also, S. HRG. 109-898 at 518-19.
60. S. HRG. 109-898 at 628.
61. "The Samberg-Microsoft investigation is on hold until David Anders and the FBI speak with David Zilkha." June 29, 2005, e-mail from Aguirre to his Assistant Director, S. HRG. 109-898 at 240.
62. Declaration of Gary J. Aguirre in Support Of Plaintiff's Cross-Motion for Summary Judgment in Part and Opposition to Defendant's Motion for Summary Judgment in Part, ¶ 23, *Aguirre v. SEC*, Case No. 1:08-cv-01872-ESH, PACER Doc. No. 37-2, Filed April 12, 2010. (hereafter "Aguirre Declaration").
63. Aguirre Declaration.
64. Aguirre Declaration.
65. Aguirre Declaration.
66. Aguirre Declaration.
67. Aguirre Declaration.
68. Aguirre Declaration.
69. Aguirre Declaration*;* also, January 2, 2009, Aguirre's letter to Chairman Cox, *available at* http://www.whistleblower.org/storage/documents/AguirreLetter.pdf.
70. *Supra*, n. 62.
71. *Supra*, n.69 .
72. *Supra* n. 26 and 69.
73. Liz Moyer, *Scales of Justice Look Skewed for Rajaratnam, Samberg*, May 27, 2010, Forbes.com; *available at* http://www.forbes.com/sites/streettalk/2010/05/27/scales-of-justice-look-skewed-for-rajaratnam-samberg.
74. *Supra*, n. 9.
75. S. HRG. 109-898 at 628.
76. S. HRG. 109-898 at 1310.
77. S. HRG. 109-898 at 1310.
78. S. HRG. 109-898 at 628, and *supra*, n. 27.
79. Director Thomsen testified before the Judiciary Committee on December 5, 2006, that no such system existed. S. HRG. 109-898 at 1280.
80. Reuters. *Former Executive Pleads Guilty,* NY Times, October 23, 2002, at C2.
81. October 8, 2004, e-mail from Aguirre to his superiors, S. HRG. 109-898, at 119.
82. S. HRG. 109-898 at 119.
83. Report at 16, quoting Foster's September 15, 2006, Senate interview transcript, S. HRG. 109-898, at 965.
84. Report at 17.
85. S. HRG. 109-898 at 1310.
86. In April, the U.K.'s Financial Services Authority was replaced by two separate regulatory authorities, the Financial Conduct Authority (FCA), an independent agency, and the Prudential Regulation Authority (PRA), an arm of the Bank of England.
87. S. HRG. 109-898 at 109-696.
88. Gretchen Morgenson, *Whispers of Mergers Set Off Bouts of Suspicious Trading*, NY Times, August 27, 2006, at A1.
89. S. HRG. 109-898 at 1280.
90. S. HRG. 109-898 at 1280.
91. Report at 1-2.

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92. Report at 2.
93. Deputy Associate Director Peter Bresnan said: "Not every hedge fund manager can get those kinds of return through legitimate trading." The New York Regional Office was "actively studying the relationships that hedge funds have both inside the hedge funds and outside" "to see how information flows… ." Report at 2.
94. *SEC v. Berlacher et al.*, 2007 SEC LEXIS 2033 (SEC 2007).
95. *In the Matter of Robert D. Babcock*, 2008 SEC LEXIS 2932 (SEC 2008).
96. Andrew Clark, *US Regulator on the Hunt for Insider Trading at Hedge Funds*, Guardian, September 19, 2007.
97. *SEC Sends Subpoenas to More than 50 Hedge Fund Managers*, Infovest21, July 15, 2008.
98. Devin Leonard, *The SEC: Outmanned, Outgunned, and on a Roll,* Businessweek.com, April 9, 2012, *available at* http://www.businessweek.com/articles/2012-04-19/the-sec-outmanned-outgunned-and-on-a-roll#p6.
99. Order in *US v. Rajaratnam*, *supra*, n., 1, at 37-38.
100. John Letzing, *Embattled Hedge Fund Galleon to Close*, Marketwatch.com, Oct. 21, 2009, *available at* http://www.marketwatch.com/story/embattled-hedge-fund-galleon-to-close-wsj-2009-10-21-1912240; Peter Lattman, *Court Upholds Rajaratnam Conviction*, NY Times, June 24, 2013, at B1.
101. Gregory Zuckerman and Kara Scannell, *Top Fund to Shut and Firm Faces Probe*, May 28, 2009, W. St. J., *available at* http://online.wsj.com/article/SB124345809322059817.html; also, *supra*, n. 9.
102. Peter Lattman and Andrew Ross Sorkin, *A Titan under a Microscope*, NY Times Blogs (Dealbook) May 6, 2011.