

Ramki

# **LESSONS FROM SAC CAPITAL**

# Sac capital's compliance systems

- SAC had one of the most rigorous and 'cutting edge' hedge fund compliance programs in the country!
- It spends tens of millions on compliance
- 38 full time compliance personnel!
- Employs some of the most aggressive communications and trading surveillances in the industry.
- Big time lawyers were hired to oversee compliance
- Had training programs which included requiring employees to certify adherence to a compliance manual and attend sessions with prominent outside speakers like Mr.Pitt, Stephen Cutler- Ex-SEC
- So what went wrong?
  - First let's see what happened...

# SAC and its owner steven A.Cohen

- SAC capital is a very successful Hedge fund firm with outsized trading profits
- Owner Cohen is ranked 121st among the world's billionaires with \$9B
- He is one of the biggest art collectors of the world
- SAC managed \$15B at beginning of the year
- This includes a large part of his own wealth
  - Investors have withdrawn about \$5B in recent months

# Government case

- Federal prosecutors in NY have charged SAC capital advisors on wire (1 count) and securities fraud(4 counts).
- Indictment is filed under theory of corporate criminal liability.
  - This is done after 2002 when it was last done in Enron.
- SEC filed a civil action suit recently on Mr. Steven. A. Cohen accusing him he did not 'reasonably' supervise his employees who are suspected of insider trading.
- Government will pursue heavy penalties, staking claim to 'any and all assets' of SAC.

# Government case contd.

- SEC calls SAC 'a veritable magnet for market cheaters'
- 'Rampant insider trading' having no equal (compared to Ivan Boesky, Michael Milliken and the recent Raj Rajaratnam case)
  - "Substantial, pervasive and on a scale without known precedent in the history of hedge funds'.
- Insider trading from 1999 to 2010
- Firm recruited employees who possessed 'an edge', euphemism for 'insider trading'
  - The word edge is used by SEC, 14 times in Government indictment and Cohen now hates the word!

# proof offered by government

- One message for a prospective hire said " the guy knows the quarters cold, has a share house in the Hamptons with a senior executive (CFO) at a big industrial co."
- Another prospect was praised for "mining his industry contact network for data points"
- An employee was supposed have 'black edge' i.e secret info which guaranteed success.
- One cooperating employee Richard Lee pleaded guilty ; Lee was hired despite warning from previous employer that he was part of an insider trading group.

# Proof offered by Government contd.

- One email about Sun Microsystems by an SAC Analyst states: "My edge is contacts at the Company and their distribution channel"
- In an IM, an employee informed that he planned to bet against Nokia shares and stated he was being cryptic, as SAC compliance chief was giving him Rules 101 -so he won't be saying much.
- An Email in 2008 of an SAC analyst to Cohen talked of a " "2nd hand read from someone at Dell"
  - Mr. Cohen sold his entire holding in Dell.
  - Cohen sent an email to the employee Steinberg "Nice job on Dell";
  - SAC avoided losses of \$1.7M
- Elan /Wyeth were other companies whose stock was traded using insider info.
  - Wire and security fraud provisions allow evidence of conduct outside the limitation period so long as there is at least one act within that period.

## Proof offered by government contd.

- Altogether five former SAC traders have pleaded guilty.
- There are insider trading indictments of two more
- Then there is SAC's own settlement with SEC in Mar 13, for \$616M, the largest insider trading penalty ever.
  - relating to insider trading involving a clinical trial for a new Alzheimer's drug.
- Indictment from 99-2004 involving Intel, Altera and AMD can be used to prove that SAC engaged in fraudulent schemes.



# The biggest fraud

- The largest trades in the indictment involve Mathew Martoma
  - He is not cooperating
- He is accused of helping firm realise profits or avoid losses to the extent of a whopping \$276M
- Martoma had 'industry contacts beyond management" in Pharma field.
- He is accused of using tips from a doctor who had access to info on drug trials to recommend Cohen to sell his stake in 2 drug companies.

# The prosecutor

- The Prosecutor is Preet Bharara
  - behind 73 guilty pleas in insider trading cases.
- After he took over, he began focusing on 'creeping culture of corruption' across politics, Wall street and in business.
- He told a group of fraud examiners that they were doing "God's work"
- Followed that up with a quote from 1994 film 'Pulp fiction':
  - " The path of the righteous man is beset on all sides by the inequities of the selfish and the tyranny of evil man"

# Defense by sac capital

- Firm spokesman "SAC has never encouraged , promoted or tolerated insider trading."
- Cohen does not see all his mails as he receives thousands; he uses seven computer screens that display e-mail; he did not read the mail which is shown as proof by Government.
- The source itself was a 'lawful' source, an authorised person in the Company
- Info. in email turned out to be wrong
- SAC sold the stock as one Mr. Plotkin had sold (he had recommended the stock to SAC initially)
- Cohen himself has sent to compliance a case on his own initiative and the Chief compliance officer told individuals to unwind the trade and firm imposed significant financial penalties on the employees.
  - These defenses are expected to be weak

# Defense by sac capital contd.

- Cohen has two of the world's most sophisticated law firms defending him.
- The criminal charge will be defended by the firm Paul Weiss which defended Michael Milliken.

# Potential punishment

- SEC could ask for Cohen being barred from stock trading for other investors for life.
- \$100M fine for securities fraud violation for 4 securities.
- On wire fraud, fine can be twice then gain from violation and hence Martoma case is crucial.
- He may lose his fund or a lot of his fortune; but he won't be behind bars as he himself is not charged.
- The major case is the civil money-laundering charge against the firm
- If fund had invested proceeds of illegal insider trading into its capital, entire pool is tainted and subject to forfeiture.
- They can go after Cohen's personal assets including his house, his art etc

# Lessons

- Just because you have put in place a very good looking system, it does not mean it works
- SAC Capital itself says: "The best compliance program may not detect individuals determined to evade firm policies or break the law."
- Also what is the 'Tone at the top'?
- Are the systems 'lip service' or 'real'?

# Lessons contd.

- Indictment emphasizes inadequacy of SAC's Internal controls in 5 pages!
  - *How does this happen time and again in such big companies?*
- Action taken internally when Compliance found deviations
  - It is found past violations were treated lightly
    - “Only one case identified by internal compliance program and employees were fined but permitted to keep jobs and no report made about the violations.”

# Lessons contd.

- Are the systems being followed?
  - One former employee said SAC employees were adept at evading compliance efforts.
  - They used private mails and kept notes on encrypted drives.
    - *How does a Company find out these? Should companies monitor private mails of employees?*
  - Firm paid the sources through trading commissions to disguise that it was using expert networks to talk directly to employees of public cos.
    - *How did the compliance team check these possible evasions?*
  - How did the firm hire someone after the previous employer said that he was engaged in insider trading?
    - *Who approved such a recruit?*



# Lessons contd.

- Harvey Pitt , former Chairman SEC says:
  - " when it comes to compliance, you have to live, eat, breathe and drink it. It has to be embedded in a firm's DNA."
    - *Are your systems and controls part of firm DNA?*
  - "It was check-the-box mentality , not a serious commitment."
    - *Is your GRC team committed or is happy to check the box?*
  - "If you read the Constitution of old Soviet Union, you'd think it was a perfect democracy"
    - *Are your manuals and systems like the Constitution of erstwhile Soviet Union? Or truthful?*

# Sources

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