Raj Rajaratnam: Insider Trading

In 1997, Raj Rajaratnam founded the Galleon Group, which would go on to become one of the largest hedge fund management firms in the world. Rajaratnam was a former lending officer at Chase Manhattan Bank and equity research analyst at Needham & Co., where he rose through the ranks to become president in 1991. He found success by investing primarily in healthcare and technology companies throughout the 1980s and 1990s. By the time he founded Galleon in 1997, he had developed a savvy reputation for finding promising technology investments and being on the cutting edge. Galleon invested rapidly in high volumes, and at its peak in the 2000s, managed over $7 billion. By 2009, Rajaratnam had a net worth of more than $1 billion. But by the end of 2009, Galleon closed its doors.

Rajaratnam was the subject of an insider trading investigation by the U.S. federal government. In 2009, he was arrested by the Federal Bureau of Investigation and charged with 14 counts of securities fraud and conspiracy. Electronic records and wiretapped conversations exposed numerous communications he had with insiders at companies including Intel, Advanced Micro Devices, Clearwire, Google, Hilton, Akamai Technologies, and Goldman Sachs. These communications included insider information which Rajaratnam used to trade these and other companies' stocks. In advance of Goldman Sachs' earnings announcement, for example, Rajaratnam was recorded telling an employee, "I heard yesterday from somebody who's on the board of Goldman Sachs that they are going to lose $2 per share… So what he was telling me was that, uh, Goldman, the quarter's pretty bad." In another conversation, a tipster told Rajaratnam, "So I think, uh, you can now just buy," referring to an upcoming deal.

Lawyers for Rajaratnam argued that all of his trading was based on publicly available information, including newspaper articles, analyst reports, and company news releases. Galleon had been known for extensive research into companies' prospects as a part of its success and edge over other investment firms. Lead lawyer John Down said Rajaratnam's success was from "shoe-leather research, diligence and hard work." The defense presented evidence, for example, of 51 news articles and six analyst reports that speculated about a potential merger of Advanced Micro Devices and ATI Technologies. This was one deal for which prosecutors claimed Rajaratnam received insider information. The prosecution agreed that Galleon regularly performed legitimate research but argued that its employees often violated securities laws, as well. Prosecutor Reed Brodsky stated, "[Rajaratnam] knew the rules, but he did not care… Cheating became part of his business model." A government investigation estimated that via insider trading, Galleon avoided losses or generated profits of $72 million in total.

In 2011, Rajaratnam was found guilty on all 14 counts of conspiracy and securities fraud. He was ordered to pay a fine of $10 million, forfeit $53 million, and sentenced to 11 years in prison. This was the longest prison term for insider trading at that time. At the sentencing, U.S. District Judge Richard Howell said that Rajaratnam's crimes "reflect a virus in our business culture that needs to be eradicated." Manhattan U.S. Attorney Preet Bharara expressed hope that this would be a wake-up call. He stated, "Privileged professionals do not get a free pass to pursue profit through corrupt means."

Concept: Deontology

Ethical Insight:

Raj Rajaratnam built a reputation for always being on the cutting edge of investing. At its peak, his hedge fund management firm Galleon Group managed over $7 billion. His firm was known for its strong research in making trading decisions, but soon it was discovered that Rajaratnam was involved in insider trading.

Insider trading is wrong, no matter which of the two classic philosophical lenses is applied – deontology or consequentialism. Deontology asserts that lying is wrong. A deontological approach condemns insider trading because lying is inherently bad and insider trading almost always involves fraud or some other form of deceit. Insider trading by what the Supreme Court calls "misappropriators" involves theft of information from those to whom the wrongdoer owes a fiduciary duty. Theft, like fraud, is also an intrinsic wrong.

A consequentialist approach decries insider trading, too, because the practice undermines trust in markets, and trust is vital to economic stability and growth. Indeed, positive economic outcomes are correlated with aggressive insider trading enforcement.

Discussion Questions:

1. Do you think Raj Rajaratnam practiced a deontological approach to trading? Why or why not?
2. Can you make an argument that insider trading should not be considered wrong when viewed through a deontological lens?
3. How might Rajaratnam's actions have differed if he took a consequentialist approach to trading? Explain.
4. Rajaratnam had a reputation for being on the cutting edge and using extensive research to make investments. Do you think Rajaratnam saw his tips as a part of his research, or that he knowingly traded with inside information? Why?
5. Assume that Tilly is CEO of ABC Company and learns that it is about to announce record annual earnings. Tilly calls her stock broker and buys ABC stock in advance of the public announcement. After the announcement, the stock price jumps and Tilly sells her shares

at a quick profit. Does this seem unfair to you? Why or why not? Is fairness also an ethical value that we should preserve?

6. In Tilly's case, the courts treat the information regarding the earnings to be a company secret that belongs to ABC's shareholders, not to Tilly. Does that make sense to you? Discuss.
7. When Tilly trades in a market where other investors do not have access to the information about ABC's earnings, no matter how carefully they do their homework, and yet Tilly does not tell these other investors about ABC's earnings, Tilly is viewed as committing a fraud by omission. Does that make sense to you? Explain.
8. Let's say Binny is a CPA and her firm puts her in charge of the audit of its client, ABC Co. During the course of the audit, Binny learns that ABC is getting ready to make an offer to buy control of XYZ Co. Binny buys XYZ shares in advance of the public announcement of the deal and sells the shares after the announcement at a profit. The law would treat Binny as a "misappropriator" who committed "fraud on the source" of the information about the acquisition. She stole information that belonged to ABC and used it for her own purposes in a way that might well cause ABC to have to pay more to complete the acquisition. Does this sound like theft that should be condemned under a deontological approach? Why or why not? Is there a way to justify Binny's actions? Explain.
9. How might investment firms guard against insider trading? How could a firm's code of ethics help this mission? What would a deontological code of ethics look like? What would a consequentialist code of ethics look like?
10. Rajaratnam's case demonstrates the pitfalls of a number of biases and behaviors. Can you identify other behavioral ethics concepts at work in this case study? Explain and discuss their significance.

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