2016

Raj Rajaratnam: Cheater (Revised)

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Though there are countless works of nature which are mesmerizing with elusive and unpredictable patterns, perhaps the leading such machination which holds the obsession of the modern world is man-made: the stock market. Marked by risk and volatility, one would think it impossible to beat the stock market game, to tether this intangible and tempestuous beast. Yet select individuals have been caught in the act of learning its moves preemptively and have been punished severely. Why? Because an enigma such as the stock market is rarely manipulated without ethically questionable scheming—which brings up the ethical issue of concern: insider trading.

I still remember my first encounter with the concept of insider trading and its fraudulent stigma. It was the spring of 2004, and I was nestled between two friends in an old fleece-lined sleeping bag as we each competed to contribute the night’s most scandalous secret. After covering the typical topics of interest, one friend leaned in with a stern countenance and delivered her winning update: Martha Stewart had gone to jail. “For what?” we asked, curious as to how the crafty celebrity could possibly be framed as a villain. “Cheating,” she answered.

Cheating: to act dishonestly or unfairly in order to gain an advantage, according to The Oxford Dictionary. Though we were young and had only the shallowest perceptions of the stock market, it was clear even then that cheating was bad and unethical. According to the U. S. Securities and Exchange Commission’s webpage on insider trading, illegal insider trading mainly consists of “buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security” The unfair advantage dishonestly created by insider trading perfectly suits the
cheating definition, and yet it is less clear, even to adults, whether or not insider trading is unethical.

To evaluate the ethical merits and demerits of insider trading, a much bigger case than Martha Stewart must be examined. While, according to a 2003 release by the SEC, Martha saved $45,673 with her insider trading by selling shares of a stock before its price fell, an individual by the name of Raj Rajaratnam was found guilty of $63.8 million (according to a June 27, 2011 article in *The New Yorker*) worth of insider trading—clearly a case of more significant magnitude. This study will first use Rajaratnam’s case to compare the ethics of legal versus illegal insider trading, then continue to examine the unethical nature of his dishonesty, gains at the expense of innocent investors, and extreme manipulation of others before concluding what (if any) the ethical course of action is in regards to the insider trading world.

Though not a household name like Martha Stewart, Rajaratnam was very well known on Wall Street for his multibillion-dollar hedge fund, Galleon. With the large influence he gained through his business, he received insider tips from large companies, including Intel, Goldman Sachs, Google Inc., ATI Technologies Inc., Akamai and Hilton Hotels Corp., which he used to make profitable stock trades, according to a May 11, 2011 article on *Bloomberg.com*. As one may have guessed, these various interactions did not take place overnight, but rather over seven years of strategic manipulation which cultivated his large sum of profits, the article explains. Despite his sly maneuvering, he eventually caused enough suspicion that in 2011 investigators wired his phone and found incriminating conversations. Ultimately, the illegal nature of his trades was confirmed, and Rajaratnam was convicted on “five counts of conspiracy and nine counts of securities fraud” and sentenced to jail for eleven years, according to the same *Bloomberg* article.
One important factor to highlight is that his inside trades were classified as illegal, though legal trades exist. That is, it is possible to make trades based on insider information within the law, as outlined on the same SEC insider trading webpage cited earlier. For example, Rajaratnam’s trades would have been legal had they been of shares of his own company and reported to the SEC. The differences between legal and illegal insider trading bring to light exactly where the ethical issues of insider trading like Rajaratnam’s stem from. While illegal insider trading is associated with acting on the secrets of other companies, legal trading involves “secrets” which one already owns. So, one may argue that an executive can do whatever he wishes with tips which were fairly obtained within his own company, especially if he reports them. Although an executive has the advantage over an outsider holding the same company stock, legal trading is not as corrupt as illegal trading, which steals secrets. Bahram Seyedin-Noor and Hollis O'Brien argued, in their article for the Markkula Center for Applied Ethics, “that a trade is legal does not necessarily make it ethical,” but legal insider trading at least takes some of the dishonesty out of the trading process, with dishonesty being an overarching ethical issue with Rajaratnam’s type of insider trading.

However, one less obvious reason why the legal version of insider trading is deemed permissible in favor of the illegal version is the added element of transparency, which Rajaratnam’s trades lacked. Once a corporate insider reports his or her inside trades to the SEC, other investors can view these trades and make more informed trading decisions as well. This increased transparency lends some light to investors as to what the true nature of a company’s confidential financials may be, which helps create equal opportunity for all investors to make informed decisions. Accordingly, as quoted in the aforementioned 2011 New Yorker article, Reed Brodsky, Rajaratnam’s prosecution attorney, asserts “the laws against insider trading are
designed to protect the investing public against cheating. The stock market is supposed to be an even playing field.” Further explained, with traditional investing, the purchasing of a stock raises its price, while the selling of said stock implies the opposite effect, with potential gains and losses corresponding with the price of the stock. Thus, the stock market ideally exposes all investors, regardless of their positions on Wall Street or corporate executive boards, to the same risk of gains and losses, as their holdings of a company’s securities are at the mercy of the company’s performance and the other investors’ decisions. Therefore, it is unethical for any single investor to have the advantage in amplifying his or her gains, as this dilutes the potential gains of other investors. As these gains simultaneously imply losses for others, gaining profits through such an unfair advantage granted by insider trading is not explicitly theft, but it is unethical.

Returning to Rajaratnam’s specific case, his insider tips were not only gained from other companies but also were obtained through dishonest means. Herein perhaps lay some of the greatly overlooked ethical discrepancies of his operations. First, he would not always receive tips from the executives of the companies he was investing in, of course, but often high-ranking trusted staff were involved, as The New Yorker article shows. In some cases, Rajaratnam incriminated individuals through manipulation before they realized that Rajaratnam had illegal intentions for the information they had given him. In the case of Anil Kumar, a senior executive at McKinsey and one of Rajaratnam’s most important informers, Rajaratnam recruited Kumar under false pretenses. In exchange for $480,000 per year, Anil agreed to be a consultant for Rajaratnam, as he “initially believed that he was going to pass information to Rajaratnam legally,” according to the New Yorker article. Though Rajaratnam set up suspicious offshore accounts and false paperwork for Kumar, The New Yorker details that Kumar was at first wary
only because McKinsey was a consulting firm and prohibited consulting outside of its own operations.

Of course, the same article goes on to reveal that Kumar soon learned that Rajaratnam was only interested in illegal insider trading and in breaching Kumar’s confidentiality agreements with McKinsey to gain the secrets of McKinsey’s clients, which consisted of technology firms in the Silicon Valley. Unfortunately, Kumar was likely already too involved to escape without repercussions from Rajaratnam, who needed his tips. As one example, given in the New Yorker article, of the countless exchanges which took place, Kumar was able to alert Rajaratnam that Advanced Micro Devices was acquiring A.T.I., a “graphics-chip company” (as described by the article), long before it was announced to the public, enabling Rajaratnam to earn a windfall by taking a long position on A.T.I.’s securities. Eventually Kumar was completely engulfed in the insider trading business, and it admittedly added to Kumar’s income, but only by a minimal amount relative to Rajaratnam’s gains. In turn, he was charged with conspiracy and securities fraud, according to a July 20, 2012 article on Bloomberg.com. However, within the Bloomberg article it is noteworthy that he received only two years of probation as punishment for these crimes because he told the whole truth of Rajaratnam’s operations to federal prosecutors. Regardless, his incrimination was a direct result of Rajaratnam’s dishonest manipulation, and his career was collateral damage.

Additionally, the other ways in which Rajaratnam solicited illegal tips were also questionable. The New Yorker depicts how he would turn two informers against each other by “disparag[ing]” and “exchang[ing] gibes” about the other informer, thus seemingly assuring both that they were his one true confidant, giving them each a false sense of protection and increasing the degree of manipulation. Many breached confidentiality agreements in order to share secrets,
which is irresponsible in a fiduciary sense and also unethical due to general dishonesty. One informer, according to the New Yorker article, even gained corporate intelligence through various sexual relations. This certainly is reminiscent of prostitution and arguably unethical in that sense. Moreover, once the profits were secured, Rajaratnam reportedly rewarded his informers with “prostitutes and other forms of illegal entertainment,” The New Yorker reveals. It is not surprising that illegal activity infiltrated every aspect of Rajaratnam’s operation, as illegal profits as large as $63.8 million are not obtained by any accident, but rather by the mind of a gifted criminal. Rajaratnam constantly prioritized his pleasure over all concern for others and ignored ethics at every turn, which makes him the quintessential illegal insider trader.

Ultimately, the only factor which is even arguably ethically redeeming of illegal insider trading, like that which Rajaratnam committed, is the efficiency it potentially adds to the market. For example, if Rajaratnam sold a large amount of stock with knowledge that a company was overvalued, the price would theoretically drop and decrease potential revenue for other stockholders. But technically, if the stock was overvalued, the market was inefficient to begin with and the price should, in theory, drop in the future in accordance with reaching the stock’s intrinsic value. However, this convergence to equilibrium is not guaranteed and would likely be less dramatic without large sales like Rajaratnam’s, and, more importantly, this is a question of efficiency rather than ethics. As stated in a December 1, 1992 article by Alexei Marcoux for The Foundation for Economic Education, while actions tend to be ethical on a binary scale, that is, either ethical or unethical, efficiency is more of a spectrum. Even accepting the viewpoint that a single action can be ethical in one sense and unethical in another, the spectrum for ethics is arguably smaller than that of efficiency, and achieving an ethical state rather than an efficient state should take priority regardless. That is, unethical actions are more detrimental to society
than inefficient actions, as the first leads to corruption and destruction of society’s structure and the latter leads to less prosperity, but not necessarily negative prosperity (i.e., destruction). This means that virtuous individuals must aim to choose the most efficient option which is ethical rather than any efficient options which are unethical, as an unethical option is destructive to society and unacceptable. Although insider trading is efficient, it is simply unethical, as argued above.

Given that Rajaratnam’s actions are widely agreed to be unethical and illegal for the aforementioned reasons, one may wonder whether his defense found any potentially overlooked ethical aspects of his actions once he faced his criminal trial. As the earlier cited *New Yorker* article states, he paid his defense up to forty million dollars in an effort to find any and all ethically redeeming qualities of his situation. However, *The New Yorker* goes on to explain that even the leading economists he hired who were strongly against market regulation (such as insider trading laws) could not successfully argue that Rajaratnam’s actions were just. In fact, the article reveals that proving his insider trading to be ethical seemed so futile that the first strategy of the head defense attorney, John Dowd, was to accuse the prosecution of lying. Kumar’s testimony, of course, proved to be accurate, and Dowd’s efforts were unsuccessful. In a further attempt to discredit the case against Rajaratnam, his spokesman, Jim McCarthy, according to *The New Yorker*, held that the wire-tapping used to incriminate Rajaratnam was unconstitutional because he considered it to be “unreasonable search and seizure,” thus breaking the fourth amendment. However, as mentioned earlier in the same article, the government’s application for wire-tapping was approved by a district judge from the very beginning, so this argument was void. Finally, when it was clear that the evidence against him was undisputable, Rajaratnam’s last defense tactic was to argue that insider trading does not exist in modern
society. According to *The New Yorker* article, his economist expert witness, Gregg Jarrell, best argued that “in the age of hedge funds and electronic communications, everything is public and nothing can be proved material—that insider trading cannot exist.” In theory, this is plausible, as most communication is now indeed fast paced and hedge funds bring prominent and knowledgeable investors together. Unfortunately for Rajaratnam, this tactic proved unsuccessful, as it is generally understood that the typical investor does not have equal access to insider information as corporate insiders, and just as prosecuting attorney Brodsky stated, “[t]he ordinary, average investor doesn’t have access to Mr. Gupta [one of Rajaratnam’s informers]” (*The New Yorker*). This is true no matter how fast secrets spread between corporate executives, thus implying that insider trading exists and his actions were still wrong.

Clearly, insider trading of all types is inherently unfair and thus unethical, though Rajaratnam’s activities were unethical on an extreme scale. The stock market is meant to be unpredictable and an outlet to support a company and profit off of its performance rather than an outlet to profit off of stolen secrets from said company and manipulative power over others. Rajaratnam hurt the investments of unknowing investors for his own gain and even ruined the career of at least one man who never intended to partake in such crimes, and his punishment is appropriate. Of course, Rajaratnam gathered enough secrets to gain tens of millions of dollars, but the money did not justify the fraud, deceit, confidentiality breaches, and innocent investors’ losses. He simply should have not committed any insider trading.

While there remains a question as to why some unethical trading is still legal, it is apparent by Rajaratnam’s several years of success that insider trading is hard to detect. Although the advantage is unfair, legal insider trading at least alerts the SEC and investors of sales so that they can become more informed. Additionally, legal insider trading allows executives to use
corporate secrets which are rightly their own. While this may be unethical, it is more understandable, and this legal insider trading should continue to exist as it regulates a process which would happen regardless of legality. Society as a whole should also aim to be as informed as ethically possible about its investments to mitigate the detrimental shocks in the market surrounding insider trading, and one should even be informed about insider trading in general so as not to accidentally incriminate oneself like Kumar. The best course of action is to allow the SEC to continue investigations such as this one and punish other guilty insider traders in order to deter others from taking advantage of this strategy which is so easy and lucrative but greatly unethical.
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