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Business Ethics

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Case study 2

Insider Trading at the Galleon Group

Born to a middle-class family in Sri Lanka, Raj Rajaratnam led the Galleon Group with a flamboyant leadership. The Galleon Group, started in 1997 was a privately-owned hedge fund firm that provided services and information about stocks, bonds and various other financial instruments. Managing portfolios and hedge funds for investors was how Galleon made money. When Galleon was at its highest, they were responsible for more than $7 billion in investor income. The company stood by the philosophy to deliver superior returns to investors without employing common high-risk tactics. Before starting the Galleon Group, Rajaratnam, worked as an analyst in Needham & Co. While working at Needham & Co., Rajaratnam developed an aggressive note-taking research strategy and networking strategy that helped him make accurate predictions about companies' financial situations. His works rose him to become the president of the company in 1991, and he also considered himself as the man who "makes things happen". However, his hunger for gathering information about other companies made him push the ethical limits. Rajaratnam's conduct became one of the major concerns at Needham and several clients of Needham's complained. His roles as the president, fund manager and sometimes as a stock analyst became a potential conflict of interest situation, and eventually Rajaratnam left the company and started the Galleon Group with a few of his Needham coworkers.

During his time at the Galleon Group, Rajaratnam contributed to various causes promoting development in the Indian subcontinent. He also conducted programs that benefited the lower-income South Asian youths in New York. He also raised $7.5 million for the victims of 2004 tsunami in South Asia. Due to these contributions and his philanthropy, he was honored with a symphony performance in New York. Besides, he also used his personal fortune for the growth of Galleon. Regardless of his charitable deeds, he was already in trouble with the government at that time. He was charged $20 million in accusation of using a fake tax shelter to hide $52million from taxation. Galleon also paid $2 million in regard to the stock trading practice investigation done by SEC. Later on, in 2001, Intel also discovered that Roomy Khan, an Intel employee had leaked company information about sales and production to Rajaratnam. Khan had to serve 6 months of house arrest after pleading guilty to fraud and agreed to cooperate in the investigation against Rajaratnam. However, the prosecutors could not prove that Rajaratnam made trades based on the information given by Khan, and hence, the investigation was abandoned.

Rajaratnam had deep acquaintances with employees at Goldman Sachs Group, Intel Corp., McKinsey & Co., and Applied Materials, Inc. Regardless of having good acquaintances, federal investigators had doubts that Galleon involved illegal methods. In 2007, SEC lawyers found a text message from Roomy Khan advising Rajaratnam to “wait for guidance” before buying a stock. After this, SEC convinced Khan to corporate with the investigation and allowed them to record her conversations with Rajaratnam which led to the discovery of several insider trading rings. Over the course of 2 years, investigators persuaded more people to participate which led to the disclosure of the central players involved in insider trading. Besides Roomy Khan, Rajiv Goel from Intel had also passed inside information to Galleon. Similarly, Danielle Chiesi from Bear Stearns shared insider information about IBM, Sun Microsystems and AMD, Anil Kumar from McKinsey & Co.

shared information about AMD, Rajat Gupta from Goldman Sachs shared information about Goldman Sachs, Proctor and Gamble and Mckinsey, Adam Smith from Galleon shared information about Galleon, ATI and AMD, Michael Cardillo from Galleon also shared inside information of Axcan Pharma, Proctor & Gamble and lastly, Zvi Goffer, also named as Octopussy, shared information about Hilton and several other companies.

Rajaratnam was arrested on 14 charges of securities and wire fraud in October 2009. Insider trading laws are vague which made it difficult to convict Rajaratnam. Prosecutors had to prove that the information he traded was confidential as well as that information was enough to affect the price of a company's stock. 45 recorded phone calls between individuals suspected of insider trading were one of the main evidence. An example of the insider trading done by Rajaratnam was with one of the board members of Goldman Sachs, Rajat Gupta, who disclosed confidential information discussed during Goldman's Sachs board meetings. The information that Berkshire Hathaway was going to invest in Goldman Sachs was released to Rajaratnam, which led him to buy 175K shares in Goldman Sachs' stocks. The same day, after the market was closed, the news about Berkshire Hathaway was publicly announced and the next morning the stocks went from $125.05 to $128.44. After the increase in stocks, the Galleon Group liquidated the stock and generated a profit of $900K. Later, it was revealed that Rajaratnam had bribed Gupta to gain insider information from Goldman Sachs. Similar to this incident, Anil Kumar was also bribed a hefty sum in exchange for insider information, by hiring him as a consultant but didn't allow him to do traditional industry research.

Rajaratnam was sentenced to 11 years in prison and his criminal penalties amounted to $63.8 million. He also had to pay $92.8 million in damages and had to pay furthermore in civil charges and other penalties. Rajaratnam and his defense team appealed the criminal conviction centering their argument on the aggressive wiretapping to gather evidence. However, the federal court of appeals found these arguments made by Rajaratnam “unpersuasive” and the U.S supreme court then declined to hear the case, making Rajaratnam’s sentence final. The Galleon then closed in 2009 after investors quickly withdrew over $4billion in investments. The illegal trades of information on over dozens of companies’ stock could’ve affected the financial status of those companies. There were more than 10 companies affected by Galleon’s alleged insider information networks such as AMD, Atheros, Axcan Pharma, Google, Goldman Sachs, Intel, IBM, Hilton hotels, Proctor &Gamble and so on. Galleon insider trading investigation was the first to use wiretaps and now many suspects that this method may be used more frequently in the future to investigate white collar crimes.

The Galleon Group were unethical in what they did. From involving in insider trading to bribery, the way they performed their tasks were illegal. Insider trading is unethical and wrong, however, despite knowing this, Rajaratnam and the team did not stop themselves from doing so. In addition to this, Rajaratnam pushed his employees to work in a non-traditional way to gain as much profit as he could. Not only did he do so in Galleon, while working at Needham & Co., he impacted the company’s culture and pushed ethical limits while gathering information about companies. The Galleon Group were also involved in tax evasion because they had used a fake tax shelter to hide a lump sum of money from taxation. Galleon Group also did not have ethical and healthy work environment. Rajaratnam took the unethical path by bribing people in exchange for inside information. For instance, he bribed Anil Kumar and Rajat Gupta with a lot of money in order to gain information and use it for his own benefit.

Instead of going forward with insider trading, the Galleon Group could have gone the traditional way of doing industry research. Studying the market trends, the companies’ financials, forecasts and future would have eventually helped them in making their decisions on whether to invest or not. This would have been an ethical way to do their job rather than doing insider trading. Also, Galleon could have used a company's annual 10K report instead of pushing their employees to ethical limits. Even though pushing to the limit and gaining information illegally would result in advantage in the competition, it would be unfair for their competitors. In the case of Anil Kumar, Rajaratnam did hire him as a consultant but made him gather information about companies in the nontraditional way. In other words, hiring Kumar as a consultant was a curtain to hide the bribery and the insider trading that was taking place. The risk of doing things the right or the ethical way would lead to less chances of profit for the Galleon group which is why they chose the other way around. Rajaratnam wanted as much profit as he could so he tried to gain advantage in finding information about companies.

The traditional industry research would be one of the solutions to this ethical issue. The best way to do something is to do it in a fair and ethical way. Galleon group could have stopped themselves from making their hands dirty and allowed their employees to involve in fair gathering of information. The satisfaction of the employees was not taken into consideration which is one of the main things that the Galleon group should have done. Also, conducting seminars about how to be ethical and assessing the company to know whether they are heading in the right direction or to know if they are doing the right thing would've helped Galleon to be successful. Hiring a consultant would've led to less frauds because there are a certain set of laws and protocols that needs to be taken into consideration. This would've resulted in proper way of administering how to gain information. However, Rajaratnam did hire Kumar as a consultant but eventually made him do unethical tasks. The Galleon Group as a whole benefitted from the insider trading and the unethical tactics they used to gain profits. The clients who invested in the group also benefitted as they received good monetary returns in their investments. However, the government was at loss because they did not get the tax money as it was hidden in a tax shelter. Besides the government, Galleon's competitors also had experienced a loss because of Galleon's unfair advantage. If the Galleon Group were an ethical company and did things the right way, there would've been a situation where everyone wins; the clients would receive their share, the government would receive their taxes, the employees would have had a chance to work in an ethical environment. However, just because doing things the right way cannot guarantee that it would always end in profit.

In this case of insider trading, there are two philosophical theories at work. One is Teleology and the other one is Egoism. Rajaratnam main goal was to find as much information about a company as they could. For him, this was his self-interest, and according to teleology, it is considered to be a right act if it produces a desired result. Regardless of the unethical choices Rajaratnam made, he followed the principles of Teleology. Egoism on the other had was also practiced by the Galleon Group. Insider trading was deemed correct for them because they were doing so to maximize their self-interest of gaining information. The way that they gained the information was not a major concern, rather gaining the information and using it as an advantage was where their interest lied upon. Galleon Group followed a culture that did not care much about their employees or their clients, but on their self-interest, which eventually led them to engage in various frauds.

References:

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