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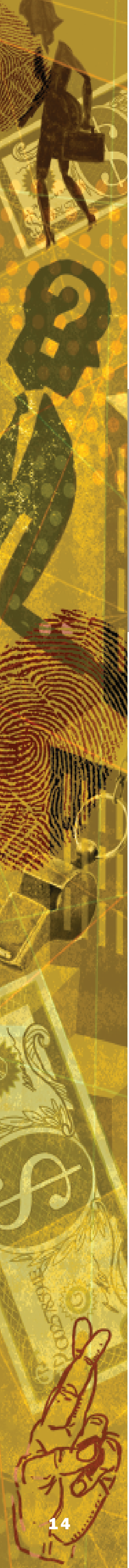

Hedge Funds Must Follow Ethical Requirements

The conviction of Raj Rajaratnam highlights several critical ethics issues concerning hedge funds. The use of expert networks to facilitate insider trading is just one example that lays bare the need for greater scrutiny to prevent unethical trading.

The murky world of hedge fund ethics became much clearer with the conviction of Raj Rajaratnam in Manhattan federal court on all 14 counts of fraud and securities law violations. In 1997, Rajaratnam founded Galleon Group, a giant hedge fund that at one time had assets of more than $7 billion. The fund closed down in December 2009 when Rajaratnam was arrested. His conviction will result in a minimum prison sentence of 15 1/2 years.

Central to the case was the apparent widespread use of paid informants to foster greed and corruption in the hedge fund industry. These individuals share sensitive and private information that's significant enough to affect the market price of a security. Hedge fund traders use this insider information to earn additional "front-running" profits by making trades sometimes only seconds before the information becomes publicly available. The cottage industry of gatherers and very selective distribution of nonpublic intelligence, known as "expert networks," earns substantial fees by feeding the voracious need of hedge funds to beat the performance of their competition by any means possible.

This revelation raises an important question: Since hedge funds appear to operate under a different set of ethics rules than other investors because they are able to obtain privileged inside information, how can regulators and legislators best prevent unethical transactions?

According to U.S. Attorney Preet Bharara, "Unlawful insider trading should be offensive to everyone who believes in, and relies on, the market. It cheats the ordinary investor....We will continue to pursue and prosecute those who believe they are both above the law and too smart to get caught." But it is the purveyors of inside information that need to be punished as much as the users. The emergence of middlemen who market secret corporate information for profit is just as unethical as the actions of those who use inside information to make illegal and unethical gains in the securities marketplace.

Regulation FD (Fair Disclosure) from the Securities & Exchange Commission (SEC) makes it quite clear that "material" and "nonpublic" information can't be selectively distributed to a small group of investors—it must have wide distribution to the investing public. This regulation applies to investment products on both securities and commodities exchanges. A level investment playing field is the bedrock basis and aim of the first securities regulation ever enacted in the United States, the Securities Act of 1933. It's called the "truth in securities" legislation and has two objectives, one of which is to prohibit deceit, misrepresentation, and other fraud in the sale of securities.

The furor in legal circles about the secret telephone recordings that were used to document the transmission of insider information seems to be a response of the defense bar. Such investigative wiretaps have heretofore been used only in cases involving organized crime and drug dealing, not white-collar wrongdoing. From a public interest perspective, more use of all possible means should be used to catch criminals and other ethics wrongdoers.

The fact that the prosecution appears to have had the resources to match whatever efforts defense attorneys put forth is viewed as pivotal to the final verdict. In spite of the fact that solving the federal deficit seems to be the number one current priority of the federal government, even more resources may be required to dig out the ever-increasing number of fraudsters on Wall Street who currently operate outside the limits of the laws and societal norms of acceptable ethical behavior.

For seven years, Galleon engaged in a conspiracy to trade securities based on inside information received from corporate executives, bankers, consultants, traders, directors of public companies, and even loose-lipped lower-level employees. These individuals need to realize that this kind of behavior is not only immoral, unethical, and illegal, but it also undercuts the entire process of fairly setting the market prices at which financial securities are bought and sold.

The network of insiders Rajaratnam cultivated to learn about nonpublic information was widespread. According to *The New York Times*, the South Asian immigrant community in New York City provided many of his tipsters. This is a relatively small group of successful Sri Lankans (like Rajaratnam), Indians, and Pakistanis who had become prominent in technology and in finance. The South Asian club at the Wharton School of Business also provided several important sources of illegal information.

A very prominent member of the intelligence-gathering group was Rajat Gupta, the chief of global consulting firm McKinsey & Company from 1994 to 2003. Gupta was a member of the board of directors of Procter & Gamble Co. and Goldman Sachs Group, Inc. Exactly 23 seconds after hearing that Goldman was going to report a loss for the first time in its history, Gupta was alleged to have called Rajaratnam to inform him of the news. Rajaratnam sold Galleon's entire stake in Goldman, approximately 120,000 shares. At the Rajaratnam trial, Goldman CEO Lloyd Blankfein testified that Gupta had violated Goldman Sachs Group's ethics code. This example highlights the importance of compliance efforts to assure ethical conduct, not just the adoption of a code. While Gupta faces a civil complaint from the SEC for his actions, he apparently isn't subject to the risk of criminal charges.

For guidance in applying the *IMA Statement of Ethical Professional Practice* to your ethical dilemma, contact the IMA Ethics Helpline at (800) 245-1383 in the U.S. or Canada. In other countries, dial the AT&T USADirect Access Number from www.usa.att.com/traveler/index.jsp, then the above number.

Another important member of the circle was Anil Kumar, a former McKinsey partner. Rajaratnam pulled Kumar aside after a fundraiser in Manhattan and made him a $500,000-a-year proposition. Kumar quoted Rajaratnam as saying, "You have such good knowledge that is worth a lot of money to me." Rajaratnam even suggested an arrangement whereby Kumar would share trading profits based on how much money his tips had made. Kumar's consulting perspective caused him to reject any kind of sharing.

During the trial, Kumar came across as a well-spoken and believable witness. His testimony as well as that of Rajiv Goel was said to be unflappable and precise. Kumar was quoted as saying he felt he "owed [Rajaratnam] something, given how much money he was paying me." Goel was a business school classmate of Rajaratnam and a former Intel, Inc. executive.

The fact that business has become increasingly globalized makes it much harder to keep corporate business secrets secure. Further, varying levels of moral values in different cultures make what is unacceptable behavior in one the norm in another. In the May 16-22, 2011, issue of *Bloomberg Businessweek*, Don Ching Trang Chu, an employee of Primary Global Research, one of the largest inside information providers, said he believes the SEC is "too strong." He arranged investor meetings in Asia because regulators aren't aggressive there. He stated that in Asia, "nobody cares."

In the same article ("Want the Scoop on Raj?"), Daniel Celeghin, a partner in a financial consulting firm, noted that "There's so much information out there, and the odds of inside information leaking have risen exponentially." He added, "It's a more cutthroat business" mirroring an ethos of profit by any means necessary. It appears the Galleon case is only the tip of

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the iceberg in terms of illegal and unethical profitability from insider trading. U.S. Attorney Bharara noted, "I wish I could say that we were just about finished investigating pervasive insider trading," He added, "Sadly, we are not."

There are several lessons to take away from the Galleon case. The most important is that there is a need to consider developing a consensus that many of the current Wall Street hedge fund strategies should be totally shut down. This will be difficult because many in Congress and the business community still favor a strategy of deregulation of business rather than focused governmental efforts in the public interest. Other lessons include the need for a federal statute to clearly define insider trading as well as the need to solve the ongoing debate and controversy over implementing the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

The last—but not least—lesson to take from the Galleon case is that investors should be skeptical of the claims of those who promise above-market returns. If it sounds too good to be true on a long-term and consistent basis, it just may not be true. The "quick buck" strategy isn't likely to be sustainable. As always, the ethical approach is the best in the long run. **SF**

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