What's Wrong with Insider Trading? Ask Raj Rajaratnam

When Raj Rajaratnam (left), founder of Galleon Management, was convicted on all 14 counts of insider trading earlier this month, it made the phones ring in lawyers' offices all across the country. Rajaratnam was only one of 47 people charged but he was by far the biggest fish caught in the net set by United States attorney for Manhattan, Preet Bharara. It took Bharara's office 9 months of wire-tapping Rajaratnam's phone, and 18 months of additional investigative work to get the convictions, and Bharara was ecstatic: "The message today is clear – there are rules and there are laws, and they apply to everyone, no matter who you are or how much money you have. "

After Rajaratnam's conviction, swtichboards at law firms have been lighting up as other hedge fund managers quizzed their lawyers with one question: "What can I legally say over my phone just in case the feds are listening in?"

The trial lasted four weeks, and the jury took another three weeks to arrive at their guilty verdict. Immediately after the verdict was announced, Rajaratnam's lead attorney, John Dowd, said they were going to appeal to the Second Circuit Court of Appeals: "The case [against my client] started out with 37 stocks. It's down to 14. The score is 23-14 in favor of the defense. " He plans on contesting the wire taps that weighed heavily in the case against his client.

One phone call that was recorded without Rajaratnam's knowledge or consent and played for the jury was from Rajat Gupta, who at the time was on the Goldman Sachs board of directors. Immediately after a board meeting when it was announced that Warren Buffet's Berkshire Hathaway was going to invest $5 billion in Goldman, Gupta called Rajaratnam who bought shares of Goldman immediately afterwards. A number of other calls that were recorded and played for the jury came from Rajiv Goel, managing director at Intel's treasury department, when he passed on Intel's earnings numbers before they were released to the public. Rajaratnam bought or sold shares of Intel based on that information.

Other companies that Rajaratnam either bought or sold depending upon the insider information he received included Polycom, Google, Hilton, Clearwire, AMD, and Akamai Technologies. Galleon's profits from these trades exceeded $60 million.

Insider trading is defined as "the trading of a corporation's stock or other securities by individuals with potential access to non-public information about the company," according to Wikipedia. The problems with that definition include: what does "potential access" mean? How is "non-public information" defined? And how can a trade in a company's stock be traced back to that information? Critics of insider trader restrictions include such highly regarded economists as Henry Manne, Milton Friedman, Thomas Sowell, and Daniel Fischel. Friedman, for example, says that all inside trading laws should be revoked because "you want more insider trading, not less. You want to give people most likely to have knowledge about deficiencies of the company an incentive to make the public aware of that. " He argued that no trader should be restricted in his decision to buy or sell a company's stock, as his participation in the market would provide all the information the market needs.

In addition, critics ask: Where is the victim of an "inside trade?" Who has been damaged? Who has been defrauded? Who has been hurt? Whenever a trade is made there must be a willing buyer on one side of the market and a willing seller on the other. Each has imperfect information, and each makes his decisions based upon his own level of expertise, insight, and understanding. Even if it were possible to give each the same information at the same moment doesn't guarantee that each would come to the same conclusion about the direction the stock might move.

And besides, making sure that every participant in the market has equal information at the same time is a myth, and efforts to make sure that all participants have equal information at the same time will fail. And why should insider trading only apply to securities? What about real estate? Do both sides of a real estate transaction have complete (and hence equal) information before completing a contract? Critics also add that attempts to disrupt or delay information flow in the effort to be "fair" infringes on freedom of speech.

Doug Casey, in a recent client newsletter, exclaimed that "Rajaratnam is – or was – a productive member of society who, even if he did break the law, may very well have done nothing morally wrong. " The SEC's rules on insider trading are, according to Casey, "stupid, counterproductive, expensive, completely unnecessary, and destructive…" The problem is with the word "fair. " As Casey put it:

> The guy who knows something and buys has not taken anything from unwilling hands – just uninformed hands – and people have to make decisions with varying amounts of information all the time. You can't regulate uncertainty or the uneven spread of information out of existence…Not only is it impossible to do, it's ethically wrong to try. If you're no good at this game, don't play it. Life's not fair. Get over it.

But Casey comes down hardest on the SEC which he says stands for "Swindlers Encouragement Commission. " By attempting to do the impossible — regulate human behavior according to a set of ever-changing rules and regulations — the SEC gives investors the impression that everything is now safe for them to play the game. He says, "By telling people it's making sure everything's fair, [it] thus lures the lambs to slaughter. The investment world is full of sharks, and it always will be – all the SEC does is lower the average guy's defenses, which really does encourage swindlers. "

The final criticism of trying to enforce insider trading laws is the means by which they are enforced. Wire-tapping of Rajaratnam's phones was obtained under criminal statues, designed to thwart violent crime. If wire-tapping can be ordered on the grounds that a victimless crime might be committed sometime in the future, what security does any citizen have against such incursions into their own private affairs?

As Doug Bandow, writing for the Cato Institute, put it:

> Laws against insider trading presume a world in which everyone can trade on perfect information. Such a world does not exist. The government should stop punishing investors seeking to act on the most accurate and timely information. After all, that's what the financial markets should be about.

Photo: Galleon Group founder Raj Rajaratnam enters Manhattan federal court on the first day of jury selection, March 8, 2011, in New York.: AP Images