The Economist

The Galleon affair

All at sea

The largest insider-trading case in decades snares a giant hedge fund

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MILTON FRIEDMAN argued for legalising insider trading on the grounds that it benefited all investors by quickly disseminating new information. These days such leave-it-to-the-market views are unfashionable. Regulators, lambasted for snoozing through the bubble, are keen to be seen rooting out manipulation. The case they have brought against Raj Rajaratnam, co-founder of Galleon, a big hedge-fund group, and five alleged co-conspirators could do much for their credibility.

At $25m, the ring's alleged profits were not unusually large. More shocking is the breadth of companies and the seniority of the individuals involved. Mr Rajaratnam, who is accused of soliciting and trading on non-public information but denies wrongdoing, is a well-known investor in technology stocks. Those said to have passed on tips about deals and upcoming earnings news at various public companies include a senior executive at IBM and employees from Moody's, a rating agency, McKinsey, a consultancy, and Intel, a chipmaker.


End of the Raj Reuters

The intricacy of this web highlights how many firms have access to privileged information from large companies. Rating agencies, for instance, are told about pending deals so they can be ready with upgrades or downgrades when the announcement comes. In this case a Moody's analyst, who has not been charged, allegedly received $10,000 for letting slip that Hilton Hotels was about to be bought by Blackstone, a private-equity firm.

Insider trading can be hard to prove. The recipient of information must be shown to have encouraged or known about a breach of fiduciary duty. The line between legitimate research and ill-gotten information is fuzzy. There are other quirks. An insider-trading case against Mark Cuban, owner of the Dallas Mavericks, a basketball team, was dismissed in July because he had not promised not to trade on sensitive information.

Nailing hedge funds can be particularly difficult. Many trade in and out of stocks so frequently—Galleon might do so more than 1,000 times a day—that it can be hard to link wrongdoing to specific transactions. Front-running takeovers is just one concern. Funds can exploit small price movements, often caused by mundane news—about, say, product development—and use derivatives to magnify gains.

The case against Mr Rajaratnam is based in part on the novel use of wiretaps, a technique previously reserved for blue-collar criminals such as mobsters and terrorists. According to the complaint, he was taped telling a co-conspirator to "buy and sell and buy and sell" shares in AMD, a technology firm, to avoid drawing attention to illicit trades. Galleon's traders were encouraged to sail close to the wind—as one put it, you "get an edge or you're gone". Investors are now flocking to pull their money out, prompting Mr Rajaratnam to say on October 21st that he would wind down Galleon's funds. The affair even rocked share prices in his native Sri Lanka.

Regulators are looking to gain an edge, too, by stepping up their data-mining efforts. The Galleon case benefited from the detection of suspicious trades by the New York Stock Exchange's systems. They are also looking for help from poachers-turned-gamekeepers, such as the Goldman Sachs man hired to help shake up the Securities and Exchange Commission's enforcement division. Officials warn of more big cases to come. Friedman would not be amused, but many will be only too happy to see more Wall Street grandees in cuffs.

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