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Sujata Srinivasan/ Forbes India

Rajat Gupta's conviction highlights the US government's efforts to crack down on white-collar crime

Depending on the perspective, the conviction of Rajat K Gupta for insider trading by a federal court in Manhattan is either a Faustian morality tale of caution, or the Orwellian story of a man victimised by Big Brother.
Opinions aside, it's a stunning fall from the greatest heights in corporate America for the 63-year-old former head of McKinsey & Co, and ex-director on the boards of Goldman Sachs, Procter & Gamble, and AMR Corp, parent company of American Airlines.

Gupta's conviction is part of the US government's extensive crackdown on white-collar offences - the number of investigations has steadily risen since the financial crisis and the subsequent economic downturn.

Since 2008, securities and commodities fraud investigations jumped by 52%, and the Federal Bureau of Investigation (FBI) has more than 1,800 investigations currently pending. The number of FBI agents hired to work on these investigations has increased by 61%. There are now approximately 91 additional agents since 2008.

In April of this year, while addressing the Miami Chamber of Commerce, FBI director Robert S Mueller said that in 2010, the agency began embedding agents at the Securities and Exchange Commission (SEC). "This allows us to see tips about securities fraud as they come into the SEC's complaint centre…to identify fraud trends more quickly and to push intelligence to our field offices," Mueller said, according to the FBI website.

The crackdowns have moved at a rapid pace. Bloomberg reported that to date, the US government has brought cases against 68 traders and their sources. Nobody has been acquitted so far and six cases are currently pending. "We are very pleased with the guilty verdict in the Gupta case, and are continuing to build other equally strong insider trading cases. Corporate America can expect insider trading investigations and prosecutions to continue to be a top priority for the SEC's Division of Enforcement," says Sanjay Wadhwa, who is heading the SEC's civil case against Gupta. That trial is currently scheduled for October 1 of this year.

The writing on the wall is clear: Wall Street, be afraid. To really get the point across, the FBI decided to rope in a movie star. In February of this year, Michael Douglas made a free public service announcement for the agency.
Looking piercingly at the camera, he says: "In the movie Wall Street I played Gordon Gekko, a greedy corporate executive who cheated to profit while innocent investors lost

their savings. The movie was fiction, but the problem is real. Our economy is increasingly dependent on the success and integrity of the financial markets. If a deal looks too good to be true, it probably is."

The Big Three - FBI, SEC and the Department of Justice - are increasingly collaborating to take down the bad guys and gals. Preet Bharara, who led the current Justice Department's criminal case against Gupta, said in a press release dated June 15: "Having fallen from respected insider to convicted inside trader, Mr Gupta has now exchanged the lofty board room for the prospect of a lowly jail cell. Almost two years ago, we said that insider trading is rampant, and today's conviction puts that claim into stark relief. It bears repeating that, in coordination with our extraordinary partners at the FBI, we will continue to pursue those who violate the securities laws, regardless of status, wealth, or influence."

But it's uncertain whether these crackdowns will have market-changing deterrent effects.

"Preet Bharara is very aggressively going after people, but Rudy Giuliani [former New York State prosecuting attorney and later mayor] did the same thing 20 years ago. He got people sentenced to substantial jail time and that didn't have a significant deterrent effect," says Charles Krakoff, managing partner at Koios Associates LLC in Massachusetts.

He also points out that despite the crackdowns, some just walk away with a slap on the wrist. JP Morgan Chase, Goldman Sachs and Citigroup all agreed to a financial settlement with the SEC over charges of defrauding investors.

"They paid fines but no one admitted their guilt. None of them were prosecuted like what the Feds did to Arthur Andersen in the Enron case. The government put the firm out of business," he says.

Even so, Krakoff thinks the investigations are necessary because capital markets are increasingly favouring wealthy investors and there's a sense that the game is run to the benefit of insiders. "These prosecutions would restore public trust in capital markets," he says.

Some believe part of the problem lies in huge rewards.

"What I fear is that individuals will continue to get tempted by the big profits - the rewards we saw in the Galleon case are enormous," says James D Cox, professor of law at Duke University.

He points to the fact that although human behaviour is not easy to change, prosecutions will put the brakes on wrongdoings. "Studies have shown that somewhere between 40% and 60% of price movement occurs before the public announcement of an event - such as unexpected earnings. What this indicates is that people don't do a very good job in preserving company secrets. The SEC and Department of Justice are wisely increasing

their prosecutions to create greater public awareness that this is not tolerated," he says. "Individuals like Gupta and other board members must realise that they owe a duty to the corporation not to disclose non-public information. Extracting secrets from the corporate mechanism and trading on it is just like stealing; we have to prosecute such people."

But there's a downside to the crackdowns.

"We don't want to have information flows to the board be compromised by any fear that outside directors like Gupta would trade on that information and jeopardise the corporation's interests," Cox points out. That's at the heart of concerns surrounding the so called "expert networks."

In Gupta's case, he was a director on the boards of top-listed corporations on Wall Street and an advisor-cum-investor at Galleon Group, one of the biggest hedge funds whose head, Raj Rajaratnam, was convicted for insider trading last year.
Lynn Stout, professor at Cornell Law School, says the problem is not expert networks themselves but the ethics of people within the networks.

"Interconnections are common and often useful in business. What needs to be re-examined is whether the law and the business world does enough to ensure that the people who have interconnections act with integrity," she says.

Thomas Lee Hazen, professor at the University of North Carolina (Chapel Hill) School of Law, said that centuries ago, corporate conflicts of interest were strictly prohibited in England and under such a regime, expert networks would not have been allowed. But as industry and the corporate sector took form - especially in the US - it became clear that the former strict English rule would not work. The law thus developed to allow interlocking relationships and the consequential conflicts of interest, but at the same time imposing higher standards of conduct and fairness on those who have dual or multiple positions that could create a conflict.

"The problem is not necessarily the existence of expert networks but rather the lack of controls and information barriers to protect against misuse of information and other improper advantages that may result from these interlocking relationships," Hazen says.

These concerns exist within an environment that is increasingly suspicious of capitalists. "As a result of the global economic chaos that pervades our lives, Wall Street and those that have had tremendous financial success are perceived as being part of an evil empire. It is unfortunate that such financial bias may have played a role in this verdict in a case where there was no direct proof of the crimes charged. I would expect that an appeal is likely," says Barry Slotnick, a white-collar defence lawyer at Buchanan Ingersoll & Rooney PC in New York. He is not associated with the case.

Gupta's conviction has put the spotlight on another area of concern.

“We have greatly over-criminalised corporate behaviour, but also lots of other actions,” says Mark A Calabria, director, Financial Regulation Studies at the Cato Institute. Like other free market economists, he believes that insider trading is a relatively small problem. “Most of the information eventually finds its way to the market anyway. Our corporate tax code, for instance, is a far bigger distortion than insider trading,” he says.

Pater Tenebrarum, an independent analyst in Vienna, Austria, says the crackdowns are one of the symptoms of what he calls “a negative social mood” following the housing bubble and the financial crisis in the US.

“This also happened in the 1930s. There were numerous Congressional inquiries after the bubble of the 1920s broke. This has two major reasons: One, bubbles do attract fraud, which often is unmasked when the bubble bursts. The other, negative social mood - and this is probably far more relevant to insider trading prosecutions - demands that someone be punished when a great many people lose money. The insider trading laws are very vague, which means that it is not too difficult for prosecutors to fashion a case,” he says.

Robert P Murphy of the Ludwig von Mises Institute in Alabama, which advances the Austrian school of economic thought, wrote a blog on the Rajaratnam verdict for the institute on May 16, 2011. Though he agrees that the behaviour of both Rajaratnam and Gupta would probably be criminal even in a laissez-faire world, he says in a free society, there would be no laws against insider trading. Central to this thinking is the effectiveness of private contracts concerning confidentiality.