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Corporations and Ethics:

Lessons from the Front Lines of the Financial Meltdown

THE GLOBAL FINANCIAL MELTDOWN has placed business behavior under the microscope, resulting in no shortage of guilty parties charged with responsibility for the fiasco. But which groups deserve more of the blame, and how did their behavior lead directly a global economic downturn? What lessons can we learn from these and related events, such as the recent high-profile insider trading cases? In the articles below, experts from Wharton and elsewhere try to answer these questions from an ethical standpoint. They also consider how corporations should deal with abusive regimes, another ethical challenge for companies with large global operations.

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Who Is to Blame for the Financial Crisis? No Simple Answers Emerge—nor Should They

Assigning responsibility for the global financial crisis is a complicated task. Various critics point to the private sector, the public sector, investors or consumers—or combinations of these groups—as being chiefly to blame. What seems clear, however, is that the meltdown has been marked by a lack of oversight, due diligence, moral fortitude and common sense. Nearly two and a half years after the housing bubble burst and world stock markets collapsed, and as U.S. lawmakers were considering new rules for the road in financial markets, there remained no clear consensus on who to blame or how to prevent similar crises in the future.

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Despite Attention to High-Profile Cases, Insider Trading Remains Difficult to Prove—or Even to Define

Although insider trading has become a flashpoint for criticism of the financial system, it continues to be difficult to separate information obtained legally from illegitimate insider information. Some economists still argue that insider trading should be legal, saying it's too expensive to enforce the law. Others, including Nobel Prize winner Milton Friedman, have argued that insider trading is actually a good thing, allowing market prices to more quickly reflect information about a company. But that perspective is not widespread, according to some Wharton professors, and international law is moving away from that view. Notes one, "The only reason you make a lot of money [on insider trades] is that you are hurting other people."

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Corporations Should Consider Guidelines for Trading with Abusive Regimes

When attempting to decide on whether to trade or invest in a country with an abusive regime, corporations have many factors to consider. These include the severity of the abuse, how dependent the country may be in the business sector in which a company operates, and the consequences that corporate decisions can have on local populations. The ethical challenges can be difficult to unravel, but companies increasingly will have to think through what it takes today to be a good global citizen as their customers demand more accountability.

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Illegal Insider Trading: A Reflection of Character

According to Ignatius Chithelen, managing partner of New York City investment firm Banyan Tree Capital Management, the news of illegal insider trading charges against Raj Rajaratnam of Galleon Group, a US$3.7 billion hedge fund, has inspired a round of gallows humor on Wall Street. But the charges against Rajaratnam and others also raise fundamental questions about the relationship between character and success, and why investors need to take notice of any potential red flags, Chithelen argues in this opinion piece.

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What seems clear, however, is that the meltdown has been marked by a lack of oversight, due diligence, moral fortitude and common sense. Nearly two and a half years after the housing bubble burst and world stock markets collapsed, and U.S. lawmakers were considering new rules for the road in financial markets, there remained no clear consensus on who to blame or how to prevent similar crises in the future.

"The question of blame has been one that's been on a lot of people's minds," said Wharton Dean Thomas S. Robertson, introducing a panel discussion at the end of 2009 titled "Responsibility and the Financial Crisis of 2008." Attempts to pinpoint who or what caused the global financial crisis usually results in a long list of suspects: The Federal Reserve, government regulators, credit rating agencies, the Securities and Exchange Commission, subprime lenders and borrowers, and even business schools have found themselves at the end of an accusing finger. "Whether they bear some responsibility or not," Robertson said, "we have an obligation to immerse ourselves in the question, 'Where do we go from here?'"

The panel of professors from Wharton and the University of Pennsylvania spread the responsibility around. The possible culprits they identified ranged from global capital imbalances to outdated regulatory structures. Some found fault with the private sector and greed on Wall Street, while others argued that the government had not been held fully accountable for its failures. Perhaps the only common ground was a belief that there are no simple solutions. Oversimplification of complex problems is dangerous, some warned, and in itself might have contributed to the crisis.

According to Wharton finance professor Franklin Allen, there hasn't been enough focus on the real causes of the financial crisis, which he traces to loose monetary policy and global capital imbalances. "The public sector has done a very successful job of pushing blame to the private sector," he said. "So for example, there's a lot of debate about consumer protection, but not the Federal Reserve .... There is little talk of reform of the global financial system."

The immediate cause of the crisis was clearly the housing bubble, Allen said. From 1890 to 1996, real housing prices

rose 27%, whereas between 1996 and 2006, they rose 92%. "That's more than three times as much. And that's the problem." The more important question is what caused the bubble. In Allen's view, subprime mortgages were not to blame, because other countries without subprime mortgages also suffered housing bubbles. Rather, the problem was that the Fed kept interest rates too low for too long, and imbalances in global capital flows allowed people to borrow large amounts at low rates. "It became a very attractive arbitrage to borrow and buy houses," Allen said.

He traces the global imbalances back to the Bretton Woods Agreement of 1944 and the Asian financial crisis of 1997. Since Bretton Woods smoothed financial conflict after World War II, the world's financial system has been dominated by the United States and Europe. As a result, Asia had little representation at the International Monetary Fund when its financial crisis unfolded in 1997. Unable to get the loans they needed during the crisis, Asian countries subsequently piled up safety stashes of $4 trillion in foreign reserves, money that ended up being invested in U.S. debt and contributing to the housing disaster.

The U.S. now borrows more money than any other country in the world, noted Wharton management professor Mauro F. Guillén, who also saw global capital imbalances as one root of the crisis. Guillén argued that the crisis "should be seen in the wider context of what is going on in the world." For example, from a regulatory standpoint, one crisis contributor was the fierce competition between London and New York about who would have the lowest financial regulations—what Guillén called a "race to the bottom" in regulatory terms. London began to compete aggressively in the 1980s to woo financial firms back to England. The U.S. responded by easing financial regulations in the 1990s, eventually repealing the Glass-Steagall Act—a Depression-era law that barred commercial banks from engaging in investment-bank activities, and vice versa—in 1999. But the easing of regulations in the U.S. included no reform of its regulatory structure, which remained a hodge-podge of agencies inherited from the Great Depression. The result was "regulatory fragmentation," Guillén said. "No agency had a 360-degree view."

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>
> William W. Bratton, Professor, Georgetown University Law Center

Wall Street's 'Self-Selected Group'

Larry Zicklin, clinical professor of business ethics at New York University's Stern School and a senior fellow at Wharton, took a different view of the crisis, placing blame squarely on Wall Street and the private sector. "I would argue that greed overcame due diligence," said Zicklin, who noted that incentive systems got out of control. "We're a self-selected group in Wall Street. Who goes to Wall Street? People who want to be rich." As long as there was money to be made in the housing market, leverage was allowed to increase. Homes were sold to people who could not afford them because the assumption was made that prices would continue to go up. "Compensation was an issue; risk was not an issue," Zicklin said. "Big firms like Lehman forgot who they were and what they were supposed to do."

Greed may have played a role in the crisis, but focusing too much on compensation of "greedy executives" just takes attention away from more serious issues, argued Wharton legal studies and business ethics professor Diana C. Robertson. "Do we have sufficient consistent empirical evidence to suggest that executive pay packages led to excessive risk-taking, as has been alleged? Would we still have a financial crisis if the pay schemes had been different? It is difficult to say. Wouldn't it be of greater benefit to focus on risk itself, on leverage, on the models used and on accountability? If we change the compensation without changing these, it seems likely that we could end up with another financial meltdown."

In terms of the public-private sector debate, "the financial crisis reveals a curious asymmetry in our responses to Wall Street and government," said Wharton legal studies and business ethics professor Amy Sepinwall. "Both are reported to have failed spectacularly but, in the case of Wall Street, the failure is seen as an expected lapse, while in the case of government, it is seen as a calamitous disappointment."

Sepinwall suggested that individual investors share as much responsibility as Wall Street for the crisis. "Wall Street is in the business of courting risk, and it is in

the business of courting risk because the investing public has given it that mandate," she said. "Individuals prefer to spend rather than save, and, as a result, demand the kind of financial alchemy that can transform one's house into a virtual ATM, or one's exceedingly modest savings into a fiscal cushion that can sustain a long, comfortable retirement. Fund managers are willing to oblige .... Risk, then, is the inevitable price of our preferences for leisure over toil and consumption over savings."

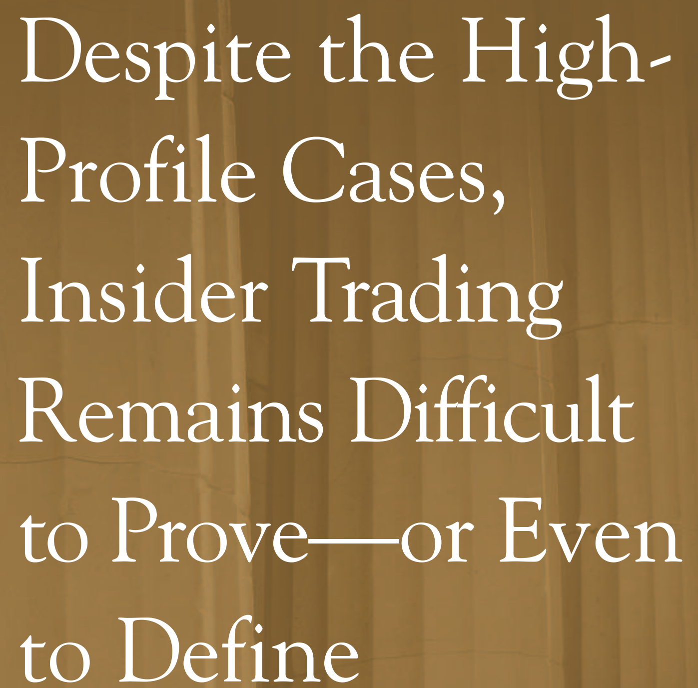
Wharton legal studies and business ethics professor David Zaring sees the crisis as "a failure of institutions. In a global world, you would think that there would be a global response" to such a crisis, but most of the world's financial networks failed. For example, the Basel Committee on Banking Supervision, a global forum established to improve cooperation and banking supervision worldwide, "had literally nothing to say in response to the financial crisis. To any extent we've seen a global response, it has come from the politicians."

Both the public and private sector share blame for the crisis, suggested William W. Bratton, a visiting professor at the Penn Law School from Georgetown University Law Center. "This was not the unforeseeable perfect storm," said Bratton, who argued that both former Federal Reserve chairman Alan Greenspan and the banks that made risky loans could have seen the crisis coming. "In the years leading up to the crisis, more and more smart people on both sides of the public/private divide were looking harder and harder at systematic risk. Why didn't anybody look at the markets and connect the dots?" Bratton asked. "It was partly because the core dots were financial products that were supposed to make the system safe, diffusing rather than concentrating risk; and it was partly because nobody had a complete set of information gathered for the purpose of dot connection. And I think it was also because those responsible were very content to operate in a political economy built on the idea that markets control business better than government does."

Such simplistic beliefs themselves may have contributed to the financial crisis, suggested Wharton management professor Witold Henisz. "The responsibility for the current crisis and its predecessors lies in an oversimplified dogma or political doctrine that—while once necessary to achieve political support to undertake reforms needed to emerge from a crisis—continued forward in self-purification and extension in a manner that ultimately sowed the seeds of its own demise. Simple policy answers—e.g., 'markets work,' or 'markets need to be controlled or regulated by government'— ... lose sight of the complexity, contingencies and uncertainty that characterize reality. Eventually, hubris sets in as policymakers, academics and those listening believe the simple answers. In short, policy proponents begin to drink their own Kool-Aid."

It is increasingly accepted that "some of the fundamental assumptions used to craft our market models do not accurately represent the actions of individuals," Henisz said. "Perhaps we could previously ignore the role of guile, framing, envy, herding, fear, loss aversion, fairness and reciprocity—as well as procedural justice—but in thinking through the ... financial crisis, I would argue these known behavioral traits must be moved from the shadows of electives, final weeks of courses and final minutes of classes to the forefront of managerial education and research."

Guillén agreed. There is no simple solution to the crisis and no single scapegoat, he said. "You are deluding yourselves if you think you can find a solution to prevent this from ever happening again. We have to learn how to lead with uncertainty." ✦



Despite the High-Profile Cases, Insider Trading Remains Difficult to Prove—or Even to Define

Although insider trading has become a flashpoint for criticism of the financial system, it continues to be difficult to separate information obtained legally from illegitimate insider information.

When federal prosecutors charged one of America's wealthiest people with insider trading in the fall of 2009, the case against Raj Rajaratnam and his firm, Galleon Group hedge fund, seemed notable for the types of evidence gathering investigators claimed to have used on the six defendants: bugged conversations and inside informants. Many allegations of insider trading are hobbled by weak evidence like suspicious stock trades just before key corporate announcements.

Since the case broke in mid-October, 2009, it has widened. Prosecutors described a network of conspirators who earned at least $60 million. Aside from being the most sensational insider trading case of recent years, and the biggest ever to involve a hedge fund, the Galleon case raises questions about what exactly constitutes insider trading at a time when so many market participants, such as hedge funds and other opaque investment pools, live or die on their ability to gather information that competitors don't have. Regulations on insider trading have gradually tightened over the years in the U.S. and many other countries, but some economists argue for a complete course reversal, making insider trading legal.

"I think there are some libertarians who think we should allow it," says Wharton finance professor Jeremy J. Siegel. "But I think insider trading is not a good thing. It makes it more risky to buy securities. When someone is offering to buy or sell, it might be that he or she has some inside information and you are going to get duped. So you cannot trust that you are going to get a fair price." Put simply, insider trading means other investors pay more than they should when they buy and get less than they should when they sell.

Although studies indicate there are a good deal more insider trades than insider trading prosecutions, Siegel does not believe it's a major force in the financial markets. "When we consider the trillions and trillions of dollars that we trade up and down, I think most of that is on the up and up," he says.

Nonetheless, it's important to prosecute insider trading cases because the practice can hurt individual investors and undermine the public confidence that allows firms to raise money in the capital markets, says Eric W. Orts, professor of legal studies and business ethics at Wharton. "The danger is you lose a broad public faith in the markets, and people take their money out."

While insider trading cases come along fairly frequently, their volume is minor compared to crimes like murder, rape and robbery. But that doesn't mean insider trading is rare. Orts says numerous academic studies indicate quite the opposite by uncovering indicators like spikes in a stock's trading volume just before key information, such as quarterly earnings, is made public. "There are a number of studies that indicate a lot of insider trading is occurring," he says, adding: "Usually there is a radical increase [in trading] before the public announcement of the event. So the question is: What is explaining that increase . . . ? And the best explanation is that somebody is getting the information ahead of the news."

Insider trading does not leave clear tracks, like a bloody victim or empty safe, so cases can go undetected. "It's hard to know how much criminal conduct goes on in the world, especially in the white collar world where there's a lot of protection of secrets," says Alan Strudler, professor of legal studies and business ethics at Wharton.

Also, an anti-regulation policy during the Bush and Clinton years left the Securities and Exchange Commission and other enforcers with thin resources for investigating insider trading. These crimes are getting more enforcement emphasis under the Obama administration. Finally, insider trading is tough to prove, with a conviction often pivoting on a judge's or jury's view of whether a defendant really knew that information was not yet public.

Subtle Distinctions

Generally, insider trading means profiting on "material, non-public information." It can be committed by an insider, such as a company executive, or an outsider who gets information from an insider. Merely obtaining inside information is not illegal. A journalist, for example, can use inside sources to glean earnings data before it is disclosed and legally use it for a story. But the reporter would be breaking the law if he used that knowledge to buy the firm's stock before an announcement drove the price up.

In the textbook case, it is not illegal to trade on information that one overhears on a train or at the ballpark, so long as you don't know it is material, non-public information. But an investment banker or lawyer helping a firm prepare a merger would clearly be breaking the law by trading on the information. "If something like that happens, it's really shocking in terms of corporate ethics," says Wharton finance professor Richard Marston.

Similarly, he notes that corporate insiders violate their ethical responsibilities to their own shareholders by profiting on information the shareholders don't have. Corporate information belongs to the shareholders, and they should all get it at the same time, he says.

While textbook cases are clear, in real life the distinction between legal and illegal use of information can be difficult. In principle, all investors should have access to the same information. That doesn't mean they actually all have the same information, just that anyone could get it by working hard enough. An example, says Orts, would be a trader who tracks a chief executive's movements, discovers he's meeting with merger-and-acquisition lawyers and trades on the assumption a merger is in the works. That would be legal. Getting an insider to tell you about the merger, and then trading on it, would break the law.

Marston notes that "a fine line" separates legitimate information from insider information, and that professional traders are inevitably going to have an advantage over everyone else. Letting them have a minor edge by, for example, allowing them to see other investors' trading orders a second or two before everyone else, a practice called "flash trading," probably doesn't present much of a problem, and may even make the markets more efficient, Marston argues. "But it's different when you get to the point where you're actually bribing people . . . . I think it would be a major problem if a hedge fund manager is corrupting someone at McKinsey or Intel," he says, referring to firms' defendants probed for alleged inside information.

Insider trading rules were tightened by Regulation Fair Disclosure adopted by the SEC in 2000. That rule, meant to curb the practice of company executives giving securities analysts an inside track, requires that anything disclosed to any outsider must be disclosed to the general public.

Siegel notes that much insider trading is curbed by rules restricting trading by

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insiders. Executives and many other employees, for example, are barred from trading during sensitive periods like earnings announcements. High-level insiders have to report all of their trading, not just trades in their own company's shares. "The rules are so strict about when you can buy or sell," Siegel says. "All information has to be out . . . . I think they have very tough enforcement of that."

The Galleon case stands out because prosecutors claim to have clear evidence the defendants knew they were breaking the law. They accuse those charged with making about $60 million on illegal trades, and said it was the first time court-authorized wiretaps had been used in an insider trading case. One court document says authorities developed an inside source who wore a wire to record conversations with defendants.

Rajaratnam, said by *Forbes* magazine to be worth $1.3 billion, has denied any wrongdoing, and remained free on a $100 million bond in early 2010. The federal complaint accuses him of obtaining inside information to execute trades that earned Galleon $12.7 million between January 2006 and July 2007. Other illegal trading produced millions more in profits, according to law enforcement officials, who said the inside information involved earnings and acquisitions, among other data.

The initial arrests included executives at Intel Capital, an investment wing of Intel Corp.; a director at McKinsey; and an executive at International Business Machines.

In one wiretap conversation cited in court documents, Rajaratnam and another defendant debate whether to have one of their sources continue working at IBM, or move the source to another company. In another conversation, Rajaratnam and another person appear to be aware that what they are doing could get them into trouble, according to court documents. "I'll never call you on my cell phone," Rajaratnam says, according to the filing. Other defendants made similar statements, and some used pre-paid cell phones to avoid wiretaps, according to court papers.

Mutual Back-Scratching

So far, 20 people have been charged with a variety of offenses, and five have pleaded guilty. The picture that emerges is of a kind of wide-ranging mutual back-scratching society, with members gathering and passing on information. Trading tips and favors is not, in itself, illegal—in fact, trading information is a big part of a hedge fund manager's job. But it's illegal to do that with inside information.

Some experts worry that the rise of hedge funds and similar, lightly regulated trading pools could make insider trading more common. "The more opacity there is, the more you can get away with," Strudler says of hedge funds. "And they are plenty opaque." Marston, for his part, thinks insider trading can be a serious problem in individual cases, but does not believe it has a major effect on the financial markets. "It's an irritation," he says.

But how strong is the Galleon case? Orts notes that evidence frequently sounds solid when prosecutors summarize it, but that cases often crumble. "You really have to be careful before making a judgment on this. The presumption of innocence has to be recognized." Adds Strudler: "It looks pretty bad, but the prosecutor's office is pretty good at making people look bad . . . . To get somebody on a crime you need pretty strong evidence." From press reports of the prosecution's case, he is not yet convinced the evidence is strong enough for convictions. "The line between information that's public and information that's not public, in lots of cases, is difficult [to define]."

Insider trading has not always been illegal everywhere. U.S. law has tightened considerably over the years, and it was not until relatively recently that Germany and Japan outlawed it. A 2002 study titled "The World Price of Insider Trading," published in the *Journal of Finance*, found that prior to 1990 only 34 of 103 countries studied had anti–insider trading laws, and just 9 countries had actually prosecuted cases. The figures rose to 87 and 38 by 2002.

The study's authors, Utpal Bhattacharya and Hazem Daouk of the Kelley School of Business at Indiana University, concluded that prosecutions reduced the prevalence of insider trading. Evidence was seen in a reduced cost of equity after prosecutions began, allowing companies to raise money more cheaply.

"The legal ban on insider trading is a relatively new thing," Strudler says. "The United States has been a leader in its prohibition of insider trading. It still has not spread completely over the world, but I think the perception of the wrongness of insider trading is something that has been evolving over the decades."

Still, some economists say insider trading should be legal. Some argue it's too expensive to enforce the law. Others, including Nobel Prize winner Milton Friedman, have argued that insider trading is actually a good thing, allowing market prices to more quickly reflect information about a company.

George Mason University economics professor Donald J. Boudreaux made this argument in an October 24, 2009 opinion piece in *The Wall Street Journal*: "Far from being so injurious to the economy that its practice must be criminalized, insiders buying and selling stocks based on their knowledge play a critical role in keeping asset prices honest—in keeping prices from lying to the public about corporate realities."

But that perspective is not widespread, according to Orts. "The way the law is moving internationally is clearly against that [view]," he says. "The only reason you make a lot of money [on insider trades] is that you are hurting other people." Insider trading prohibitions, he adds, are covered in a basic law class that Wharton MBA students are required to take.

In many cases, the damage from insider trading is more theoretical than observable, but not always. "Look at Enron," says Strudler, referring to the Texas energy company that collapsed in scandal early in the decade. The Enron case illustrates one of the most pernicious effects of insider trading: It gives executives a reason to distort reports on corporate performance and find other ways to manipulate markets to their own benefit, he notes. "There was insider trading there, and that was pretty damaging to the firm in the long term. It destroyed it."✦

Corporations Should Consider Guidelines for Trading with Abusive Regimes

When attempting to decide on whether to trade or invest in a country with an abusive regime, corporations have many factors to consider. These include the severity of the abuse, how dependent the country may be in the business sector in which a company operates, and the consequences corporate decisions can have—one way or the other—on local populations. The ethical challenges can be difficult to unravel, but companies increasingly will have to think through what it takes today to be a good global citizen as their customers demand more accountability.

Is selling police equipment to a notoriously brutal government tantamount to assisting in torture?

William Schulz believes that it can be, and that these types of sales are one of the principal ways in which businesses can entangle themselves with torturers.

Schulz, former executive director of Amnesty International, spoke during a recent presentation sponsored by Wharton's Zicklin Center for Business Ethics Research.

Seldom are businesses in the developed world implicated directly in torture, but too often they avert their eyes as their products, purchases or independent contractors support abuses, according to Schultz, who is now a senior fellow at the Center for American Progress, a liberal think tank based in Washington, D.C. He cited the case of Taser International, the Scottsdale, Ariz., manufacturer of "stun guns." Taser's devices, sold domestically to police departments and private citizens, shoot electrified barbs that cause a flash of intense pain and momentary muscle failure. Police use them in place of pistols and clubs to protect themselves and subdue unruly people.

The U.S. Commerce Department has documented the sale of Tasers to countries, including Saudi Arabia, that are known for using electro-shock devices as tools of torture, Schulz said. He debated Taser's chief executive, Rick Smith, three

years ago at Claremont-McKenna College in California. At the time, he asked Smith to stop selling his company's wares to countries that the U.S. State Department had classified as torturers. Taser's president indicated that the company "would sell to any country it pleased," Schulz stated.

In a response to Schulz's remarks, Taser spokesman Pete Holran noted that, "For anything that we sell abroad, we have to get a license from the U.S. Department of Commerce . . . . That licensing process has input from the State Department and many other federal agencies. They are supposed to inform us if there is a region or a regime that should not receive our devices." In addition, he said, "We don't know of any direct use of our devices for torture. Amnesty has never been able to bring that direct charge."

Electro-shock devices, including stun guns, stun belts and stun shields, are the most commonly used tools of torture after the human fist, Schulz said. As far back as 1994, Amnesty International documented their export to repressive foreign regimes. "Export license records revealed that [the U.S. Commerce Department] authorized the sale to Saudi Arabia of handcuffs and stun shields used for torture," Schulz noted. "In 1996, the department approved a shipment of thumb screws—miniature cuffs that are attached to the thumbs and are useful for nothing except torture—to Russia."

Selling tools isn't the only way in which firms find themselves linked to torturers, Schulz said. Sometimes, they hire guards who end up abusing people while protecting a company's property. Unocal, a California oil-and-gas company, for example, was accused in U.S. courts of employing soldiers in Myanmar (formerly Burma) who tortured, raped and killed villagers while guarding a pipeline. The villagers sued in the United States under the Alien Torts Claims Act, and Unocal settled in 2004.

As a result of disputes like this one, multinationals have become more assiduous in their monitoring of the conduct of security contractors abroad, Schulz said. British Petroleum, for example, has entered into an agreement with the governments of Turkey, Georgia and Azerbaijan to allow the oil company to provide human rights training to their security forces. A BP oil pipeline traverses the three countries.

The Cost of a Diamond

Firms sometimes do business directly with repressive regimes or rebel groups and, in effect, fund their practices, according to Schulz. This predicament arises most often in extractive industries, like mining and oil and gas, where the largest remaining reserves tend to be located in developing countries that either have autocratic governments or are embroiled in civil war, he noted.

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Perhaps the most notorious example is the diamond industry. In Sierra Leone and Angola, diamond sales supported insurgencies to such an extent that the United Nations adopted a resolution condemning trade in what it called "conflict diamonds." Liberia's former president, Charles Taylor, has been accused of supporting the rebels in neighboring Sierra Leone in exchange for diamonds. The rebels committed a host of atrocities, including intimidating civilians by chopping off the hands and feet of noncombatants. Taylor continues to face trial in The Hague for war crimes and crimes against humanity.

Bad publicity from products tainted by links to torture can redound to retailers, Schulz pointed out. To underscore the connection between diamonds and brutality, for example, Amnesty International and other human rights groups launched an anti-conflict-diamond campaign in the United States. An online video produced as part of the effort showed a woman's hand stretched out to receive a diamond ring, but then showed her hand being chopped off before the ring could be slipped on her finger. "That influenced a bunch of college students to go into their local jewelers and ask how much blood each diamond cost," Schulz said. "That was all it took to get the industry to quickly institute new procedures for monitoring the sources of its diamonds."

A similar conflict rages today in the Sudan, one that has been fueled by oil revenues, Schulz added. There, crude sales sustain a government that has been accused by the United Nations of committing genocide in the country's Darfur region. More than 200,000 people have been killed in Darfur and about 2.5 million have been forced from their homes. Many Western oil companies now refuse to do business with the Sudanese government, but Chinese oil firms, backed by the Chinese government, have stepped into the void. According to *The New York Times*, "Chinese oil purchases have financed Sudan's pillage of Darfur, Chinese-made AK-47s have been the main weapons used to slaughter several hundred thousand people in Darfur so far, and China has protected Sudan in the U.N. Security Council."

Schulz stressed that situations like Taylor's diamond trade and Sudan's oil both demand action because the link between commerce and brutality is so stark. In each case, trade in a commodity directly supported, or continues to

support, a group or government committing atrocities.

In contrast, Schulz said that he doesn't believe that businesses must refuse to operate in any nation with a poor human rights record. "If I could get every country that commits torture to change their stripes by threatening them with the withdrawal of investment, I would do it," he said. "But that's not a practical way to bring about change, and I don't believe that poverty is a friend of human rights. So we have to make judgments."

Consider the oil industry. The list of the world's top producers is crowded with countries that have been accused of torture. (Schulz would add the United States to that group in light of the revelations at the Abu Ghraib military prison in Iraq and the Bush administration's refusal to forswear waterboarding, a form of torture that simulates drowning, although that policy was reversed by the Obama administration.) Today's world depends too heavily on oil for companies to refuse to do business in any place where torture has occurred or been alleged, Schulz said. "We have to be selective. There are some cases in which the connection is very direct. If oil companies are directly responsible for human rights violations—as it was alleged that Unocal was—then they have to be held accountable."

Reebok's Lead

In making judgments about whether to refuse to operate or invest in a country, Schulz said that firms must consider a variety of factors. The most obvious, besides the directness of the link, is the severity of the abuses. Another is how dependent the country's government is on the sales of a given commodity. In Sudan, for example, oil is the country's lifeblood. "I don't pretend that the ethical questions are easy. You make judgments where you think you can have an impact and where the crime is serious enough."

In some cases, home governments may make decisions for companies by barring activity via sanctions, Schulz pointed out. Again, the utility of sanctions has to be evaluated case by case. Among the criteria to consider is whether the local activists have asked for sanctions as a way to pressure their government. Schulz also pointed out that sanctions and boycotts have a mixed record of effectiveness.

Declining to do business somewhere or acceding to sanctions isn't the only way that companies can forestall torture and other human rights abuses. They can also take active steps to publicize and prevent bad acts—and many of them do. Paul Fireman, chief executive of Reebok, is a case in point. "He intervened actively on behalf of the leader of the labor organization in Indonesia that had given Reebok a load of grief about its factories," Schulz said. In 1999, Fireman wrote to Indonesia's president seeking the release from prison of human rights activist Dita Sari. Fireman has also refused to do business in Myanmar, as have many companies, and, in 2005, wrote an editorial in *The Wall Street Journal* calling on corporate colleagues to follow Reebok's lead.

"More and more corporations are recognizing that it's in their interest to be good global citizens," Schulz added. "One of the most promising developments in the field of human rights during my years at Amnesty was the growing sense that human rights were good business and that countries that don't respect the rule of law, don't educate their children and don't use the talents of half of their populations because of their gender are unlikely to be places where businesses will prosper in the long run."✦

Illegal Insider Trading: A Reflection of Character

According to Ignatius Chithelen, managing partner of New York City investment firm Banyan Tree Capital Management, recent news of illegal insider trading charges against Raj Rajaratnam of Galleon Group, a US$3.7 billion hedge fund, has inspired a round of gallows humor on Wall Street. But the charges against Rajaratnam and five others also raise fundamental questions about the relationship between character and success, and why investors need to take notice of any potential red flags, Chithelen argues in this opinion piece.

Recent news of the illegal insider trading charges against Raj Rajaratnam of the hedge fund Galleon Group and five others, the biggest such case in decades, has spawned its own round of jokes on Wall Street. Who are the most sought-after professionals in finance these days? Answer: Electricians, who are experts at figuring out if cell phones, landlines or offices have been bugged by the FBI. And what is the most popular spot in New York City? Answer: The area under the Brooklyn Bridge, where in the 1980s Ivan Boesky, the last big financial executive to be convicted of illegal insider trading, was said to exchange non-public material information about stocks the old-fashioned way—directly in person.

As with most cases of gallows humor, a kernel of truth lurks in these jokes. Wall Street witnesses constant rumors about some people becoming wealthy as a result of illegal insider trading or by breaking other laws. Such stories are as much a part of the street's folk lore, the seamy underbelly discussed discreetly or after the third drink, as are the images of glamour and wealth that attract ambitious talent to hedge funds and other financial jobs. Barton Biggs, the veteran investment strategist and hedge fund manager, in his 2006 book *Hedge Hogging*, provides insights into how various hedge funds operate, by narrating stories of fictional characters. In a chapter titled "Divine Intervention or Inside Information?" he talks about Judson Thomas, a stockbroker at a third-tier investment bank, who becomes a financial guru and celebrity because of his mystical ability to read tomorrow's market-moving news in today's financial newspaper.

Some articles in the media have argued that prosecutors will have a tough time proving their case against Rajaratnam and the others. They say this is because there is a thin line between the web of legal information gathering and research relied upon by funds, and illegal insider data from sources who have a fiduciary duty to not disclose it. Indeed, the strength or weakness of the legal case could be debated and will soon be decided in a court of law. But, going by news reports, there was a breach of ethics, since prospective earnings and other stock-moving information, which was not publicly known, was apparently used by Rajaratnam to make profitable trades.

Most MBA programs—including the one at Wharton—require students to take a course in ethics, where illegal insider

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trading cases are discussed in detail. Similarly, all Chartered Financial Analysts, hundreds of thousands of whom work on Wall Street, have to pass an ethics exam. Yes, it is likely that few students took their ethics courses seriously. But at the very least, they were made aware of the right and wrong way to handle inside information, and the potential perils if they chose the wrong path. Also, funds like Rajaratnam's, which are registered with the Securities and Exchange Commission (SEC), are required to have codes of conduct under which employees pledge not to trade on inside information.

> "The chains of habit are too light to be noticed until they are too heavy to be broken."
>
> Warren Buffett,
> CEO, Berkshire-Hathaway

Character and Success

What is it that leads people, who usually have the talent to become wealthy through ethical means, to break laws like those concerning insider trading—and moreover, as was the case with Martha Stewart, to do so for a relatively small gain? Perhaps it is greed, combined with the belief that they are smart enough to avoid getting caught. By hiring the best lawyers and other professionals, preferably former regulators, and by creating a maze of reporting layers and structures, the law breakers must assume they can shield their direct involvement from legal scrutiny.

The cold calculation of the managers may be that, at worst—even if their fund's actions are minutely investigated by the FBI and the SEC—an outside consultant or in-house analyst will be found to have acted on his or her own and found guilty for carrying out the illegal work without the manager's knowledge. After all, the prospect of earning massive consulting fees or big bonuses has been known in several cases to blind some people into doing illegal work.

"The most important thing is character and the quality of the people . . . . It's everything," David Swensen recently told the *Financial Times* when asked about what he looks for in outside fund managers he hires. Swensen, who runs Yale's $16 billion endowment, has a strong long-term performance record. It is debatable whether good character is nurtured during childhood or whether it can also be acquired later in life, following repentance for wrong actions. Religious texts, philosophers and great novelists have wrestled with this question through the ages. For purposes of ethics on Wall Street, the relevant question is whether there is anything in a person's background that raises doubts about his character. Swensen joked that his team's deep due diligence includes interviewing a potential manager's high school geometry teacher.

Warren Buffett, CEO of Berkshire-Hathaway and arguably the most successful investor the world has known, expressed some timeless wisdom on the relationship between character and success during a 1999 speech at Wharton. Speaking to an auditorium packed with students and faculty, Buffett asked his audience: "If you were asked to select a person and were told that you could retain 10% of his or her earnings for the rest of your life, whom would you choose? Someone with the highest SAT or IQ test scores? Probably not. Chances are that you would pick someone with a steadfast character, whom you could trust to function well through life. Conversely, what kind of person would you shun? Most likely, the type who cuts corners and is generally undependable. Each of these qualities is a characteristic of choice and can make the difference between success and failure."

Developing characteristics such as trustworthiness and integrity, Buffett noted, is a matter of forming the right habits. "The chains of habit are too light to be noticed until they are too heavy to be broken," he said. People who stray from these values often show up on Wall Street; they may initially even shine, but eventually they self-destruct. "That is sad, because it does not need to happen," says Buffett. "You need integrity, intelligence and energy to succeed. Integrity is totally a matter of choice—and it is habit-forming."

Red Flags

In Rajaratnam's case, there was a major red flag. In 2005, the Galleon Group paid an $800,000 fine to the SEC to settle charges that it improperly profited from shorting stocks. The SEC alleged Galleon violated securities rules by using shares obtained in a secondary offering to cover pre-existing short positions. Regulators claimed the risk-less strategy generated $1 million in trading profits for Galleon.

The fine raises questions about the level of due diligence or the ethics of investors who put in billions in Galleon, including a

university endowment, even after the SEC action was disclosed. As was the case with Bernard Madoff's Ponzi scheme, if a fund manager's superior investment gains seem too good to be true, since there is no rational, verifiable explanation for the process, or there is a hint of improper activity, investors—as well as job seekers—should stay away.

According to news reports, several more people will soon be charged with illegal insider trading. If found guilty, legal experts say, Rajaratnam could spend up to 20 years in jail. Prosecutors should be applauded for seeking the maximum prison sentence. Quite apart from the public loss of face, assuming the guilty care about such things, the fear of spending years in jail should scare some people away from trying to pursue easy money by breaking laws such as those on insider trading. Maybe then there will also be more space under the Brooklyn Bridge for tourists on their way from Wall Street to New York's Chinatown. ✦

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