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District Court Denies Rajaratnam's Bid to Overturn his Verdict

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On August 16, 2011, Judge Richard Howell of the Southern District of New York denied a motion brought by Raj Rajaratnam under Federal Rule of Criminal Procedure Rule 29 for a judgment of acquittal in the insider trading case *United States v. Rajaratnam*.[1] On May 11, after an eight week trial, the jury in the case found Rajaratnam guilty on five counts of conspiracy and nine substantive counts of insider trading. After the verdict, Rajaratnam renewed an earlier motion for judgment of acquittal, claiming that no reasonable jury could have found him guilty based on the evidence introduced at trial.

Judge Howell's Order addresses a number of important issues relating to insider trading prosecutions, including a detailed discussion of co-conspirator insider trading liability and what constitutes material, non-public information. Furthermore, even though the case marked the first time the government used wiretaps to investigate and then prosecute an insider trading case, Judge Howell's decision relies heavily on the circumstantial evidence common to traditional insider trading cases, perhaps anticipating the defense's appeal on the admissibility of the wiretaps.

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Courts Split on Tippee Knowledge of Tipper Breach of Fiduciary Duty Requirement

As an initial matter, Judge Howell's Order discusses the split among courts concerning what knowledge a tippee must have regarding the tipper's breach of fiduciary duty. The Court noted that a number of cases, both criminal and civil, require only that that the government show the tippee "knew or should have known" that the tipper violated a fiduciary duty by providing the information to the tippee.[2] Here, however, Judge Howell's instructions to the jury imposed a higher standard on the government; namely, the government had to prove that Rajaratnam, as the tippee, *actually knew* that the various tippers had breached their fiduciary duties by disclosing material, non-public information to him, not merely that he "should have known" of the breach.[3] So while the issue is moot for the purposes of this case, it raises questions as to the appropriate standard required for tippee liability in both criminal and civil cases, which remains unsettled.

Indeed, Judge Howell noted that questions concerning the "knowledge" a tippee has of the tipper's breach might arise in cases of an "indirect tipper," where the tippee does not receive the non-public information from the tipper, but rather from one (or several) intermediaries. In such situations, the Court wrote, "problems of proof may arise in establishing that a remote tipper [sic] [presumably, the Court meant tippee] knows that a tip was the result of an indirect tipper's breach of a duty or trust."[4]

The potential problems of proof concerning indirect tippers would seem to be particularly relevant to the current wave of expert network cases, because the "tipper" in such cases is usually a member of an expert network and only an intermediary between the original tipper, who holds the fiduciary duty, and the eventual tippee. Judge Howell implied that the government might have a difficult time establishing that the tippee "knew" (as Judge Howell instructed the jury) or simply "should have known" (as other courts have construed the rule) that the original tipper violated his fiduciary duty in such cases when all information was filtered through the expert network firm.[5] Judge Howell went on to further parse this issue later in his Order, explaining that the existence of an initial tipper, an intermediate tippee and a remote tippee means that the remote tippee can still be convicted of conspiring with the intermediate tipper, even where the remote tippee does not know who the initial tipper is and/or whether they breached a duty.[6]

Friendship Satisfies "Benefit to Tipper" Requirement

Consistent with the Court's earlier statements, the Order also holds that the benefit to the tipper, which is required for a conviction on insider trading charges, need not be financial, and can rest instead on a friendship or familial relationship.[7] The Court concluded that passing on inside information to a friend or relative constitutes a "gift" of profits to the recipient.[8]

In fact, the Court applied this standard in analyzing the sufficiency of the government's evidence in support of its Third Count against Rajaratnam, a conspiracy to trade on inside information between Rajaratnam and Rajiv Goel. Goel testified at trial that he sought out inside information from others concerning earnings and a potential investment by his employer in another company, and then shared it with Rajaratnam simply because they were good friends.[9] While the Court held that this gift from tipper to tippee was itself sufficient to satisfy the government's burden on this element, the Court also pointed to evidence that Rajaratnam had access to and traded on the basis of inside information in Goel's Charles Schwab brokerage account, which netted Goel several hundred thousand dollars, suggesting Goel may have received other benefits.[10]

Although Judge Howell's holding that a "friendship or familial relationship" is sufficient to satisfy the "personal benefit" test in *Dirks v. SEC*[11] is not novel, other courts have held that similar relationships were exclusively professional and dismissed the charges on that basis.[12] Accordingly, there is no bright line rule regarding what constitutes such a relationship and it still turns on the facts and circumstances of a particular case.

Traditional Circumstantial Evidence is Still Important

Even though the government's case against Rajaratnam was groundbreaking in its use of wiretaps, the Court spent considerable energy evaluating the sufficiency of the circumstantial evidence, at times largely ignoring or marginalizing the government's wiretap evidence. Indeed, because "circumstantial evidence is a legitimate form of evidence in th[at] Circuit," the Court relied heavily on it in upholding Rajaratnam's conviction.[13] Given that the defense will likely challenge Judge Howell's November 2010 ruling regarding the admissibility of the wiretaps at trial, the Court's decision to thoroughly analyze the traditional, non-wiretap evidence might ultimately prove prescient.

For example, in assessing whether a reasonable jury could have concluded that Rajaratnam participated in a conspiracy with Roomy Khan, a former Galleon employee, under Count Two of the Superseding Indictment, the Court cites the mountain of evidence the government submitted to establish the conspiracy, including evidence of phone records (but not wiretaps), trading records, FedEx records, Rajaratnam's testimony before the SEC, instant messages, and testimony from others (but not Rajaratnam or Khan).[14] Similarly, in considering other counts of the indictment, the Court relied on the temporal proximity of phone calls between the alleged co-conspirators and trades reflected in trading records and unique trading patterns to draw a strong inference of insider trading.[15]

What Constitutes Material, Non-Public Information

Finally, in response to Rajaratnam's challenge, Judge Howell conducted a lengthy analysis of whether the information was non-public and whether it was material to investors. In setting forth the standard, the Court cited *SEC v. Mayhew* for the proposition that information can be considered public even if it is known by only a few persons, provided that those individuals' trading "has caused the information to be fully impounded in the price of the particular stock."[16] This concept appears contrary to the efficient market theory—which posits that a stock price reflects all *publicly* available information—because it suggests information that is not generally available to the public (only to a small, powerful group) has nonetheless been incorporated into the stock price.

In particular, the Order assessed in detail the materiality and non-public nature of the information Goel passed to Rajaratnam regarding a potential Intel investment in Clearwire (Counts Three, Six, and Seven) and Intel's Q1 2007 earnings (Counts Three and Fourteen).

The Court first considered—and rejected—Rajaratnam's argument that no rational jury could find that the information Rajaratnam knew about Clearwire was non-public, because information about the potential joint venture was disclosed in a late March 2008 *Wall Street Journal* article.[17] But even though the *WSJ* article contained very specific information concerning the potential investment, the Court pointed to a phone call between Rajaratnam and his brother Rengan discussing the article, during which the two agreed that they were in trouble because the information about Clearwire had been publicized (suggesting they would not stand to benefit from the advantage of the non-public information) and that the article was "short on details," and did not contain "equity splits" (suggesting the two might have had other information not included in the article).[18] The Court held that this evidence was sufficient for a reasonable jury to conclude that Rajaratnam knew more than the market, even after the *WSJ* article was published.

Second, the Court rejected Rajaratnam's argument that neither the Clearwire investment information nor the Q1 2007 earnings release were material. Rajaratnam relied on the testimony of an economics expert, Dr. Gregg Jarrell, who opined that none of the information Rajaratnam had about Clearwire or the Q1 2007 earnings was material because there was no statistically significant stock price movement in Clearwire's stock price (with respect to the Clearwire joint venture) or in Intel's stock price (with respect to the earnings release) after the information became publicly available.[19] In response, the Court stated that it must "resolve all issues of credibility in favor of the jury's verdict" and noted that the mere fact that the Clearwire stock price did not change significantly did not mean it was not material, because a reasonable jury could conclude that the fact that two large communications companies were engaging in a multi-billion dollar joint venture was material to investors.[20] Similarly, the Court credited the jury's finding that the Q1 2007 earnings information was material, citing concerns with Dr. Jarrell's event study raised by the government on cross-examination and testimony from others at trial that investors generally find earnings releases important.[21] The Court's holdings with respect to these issues is particularly noteworthy, because the government did not present a competing expert or any scientific evidence and chose instead to rely, successfully, on fact evidence and the cross examination of Rajaratnam's expert.

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[1] Memorandum and Order, *U.S. v. Rajaratnam*, Case No. 09-1184 (S.D.N.Y.) (Dkt 307).

[2] Order at 5 n.1 (citing *SEC v. Ballestreros Franco*, 253 F. Supp. 2d 720, 726 (S.D.N.Y. 2003); *SEC v. Warde*, 151 F.3d 42, 47 (2d Cir. 1998)).

[3] Order at 5 n.1.

[4] Order at 7 n.2.

[5] Order at 7 n.2.

[6] Order at 15 n.3.

[7] Order at 7, 23.

[8] Order at 7, 23.

[9] Order at 23.

[10] Order at 23, 33.

[11] 463 U.S. 646 (1983).

[12] *See, e.g. SEC v. Rorech*, 720 F. Supp. 2d 367 (S.D.N.Y. 2010).

[13] Order at 12.

[14] Order at 13.

[15] Order at 10; 18; 19; 27; 30; 42.

[16] Order at 6.

[17] Order at 24; 33.

[18] Order at 24; 33.

[19] Order at 33-34.

[20] Order at 34.

[21] Order at 46-47.