

# FINANCIAL FRAUD LAW REPORT

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# The Raj Rajaratnam Conviction: What Does It Really Indicate?

BARRY W. RASHKOVER, TIMOTHY J. TREANOR, AND DAVID L. ANDERSON

*The authors discuss two important lessons from the jury's decision to convict hedge fund billionaire Raj Rajaratnam.*

As has been well publicized, a New York jury has convicted Raj Rajaratnam, founder and principal of the Galleon Group, of all 14 counts charged against him in a criminal indictment.<sup>1</sup> The case is widely and correctly perceived as a seminal case in the prosecution and defense of insider trading. Many commentators have proclaimed that this will encourage aggressive prosecutions in the future, signals the end of the mosaic defense, and is a significant victory for the prosecutors. On a closer look, however, this verdict was neither the easy result the prosecutors might have expected nor the end of sound defenses in insider trading cases. In many ways, this verdict stems from unique facts not present in many insider trading prosecutions. While the full implications of the case will have to await the outcome on appeal, two lessons are immediately apparent.

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## FOR THE PROSECUTION, THIS CASE WAS A MUST-WIN, BUT NOT AN EASY WIN

In the wake of the jury acquittals in the Bear Stearns case, *United States v. Ralph Cioffi and Matthew Tannin*,<sup>2</sup> many perceived the *Rajaratnam* case to be a must-win case for the prosecution. The business and legal press covered the case for over a year. The press and prosecutors vilified Rajaratnam based on the allegations made against him. And, the prosecution's evidence packed a powerful punch in the form of 40 wiretapped calls, co-conspirator testimony obtained under the threat of lengthy prison sentences, and a secret \$500,000 a year consulting salary to a Swiss bank account of an alleged tipper in the name of a housekeeper.

Despite this extraordinary evidence, the jury deliberated for 12 days before convicting Rajaratnam. Although the replacement of a juror for medical reasons accounted for a portion of this time, jury deliberations continued for six days after the juror was replaced. The length of these deliberations suggests that the jury did not find this to be an easy case to decide, took the defendant's arguments very seriously, and closely scrutinized the prosecution's evidence.

In the end, the prosecution's victory depended on aggressive investigative techniques that now will be examined on appeal, most obviously the court-authorized wiretaps — a tactic rarely used in securities fraud cases — obtained by prosecutors against Rajaratnam and others. The court admitted those wiretaps over strenuous defense objections — objections bolstered by extensive hearings, conducted outside the presence of the jury, on the basis for the wiretap application using a procedure established in *Franks v. Delaware*.<sup>3</sup> The *Franks* hearing transcript and the defense objections preserve for appeal the defense challenges to the prosecutors' use of these wiretaps in this case.

The wiretaps effectively allowed the prosecutors to bring witnesses into the courtroom without subjecting them to cross examination. For example, one of Rajaratnam's alleged co-conspirators, Danielle Chiesi, spoke so colorfully in wiretapped calls that the court edited what the jury was permitted to hear. Because the prosecutors did not call Chiesi as a witness at the trial, however, the defense did not have an opportunity to

cross-examine her. The jury also heard statements from Rengan Rajaratnam, the brother of the defendant, but he too was not subject to cross-examination. These issues will surely be the subject of much discussion in the court of appeals.

## THE MOSAIC DEFENSE SURVIVES THE *RAJARATNAM* VERDICT

Some commentators suggested that the *Rajaratnam* verdict marks the demise of the mosaic defense to inside trading, but this verdict does not support that conclusion.

The mosaic defense sets forth the view that a market participant may trade while aware of “a non-material piece of [nonpublic] information [where]...that piece helps the analyst complete a ‘mosaic’ of information that, taken together, is material.”<sup>4</sup> In the *Rajaratnam* case, the court provided a charge that permitted the jury to acquit the defendant if it concluded that Rajaratnam was truly trading on a mosaic. The court instructed the jury that it must find that the information at issue was material at the time it was disclosed, explaining that “[w]ithin the particular context of the purchase and sale of securities, material information is information which a reasonable investor would have considered significant in deciding whether to buy, sell or hold securities and at what price to buy or sell. Put another way, there must be a substantial likelihood that the fact would have been viewed by a reasonable investor as having significantly altered the total mix of information then available.” The court continued, saying “[t]he law permits analysts and investment advisors to meet and speak with corporate officers and other insiders in order to ferret out and analyze information useful in making decisions” and that “the receipt of material, non-public information does not itself violate the law.” These instructions show that the mosaic defense remains viable as a matter of law.

The court also permitted Rajaratnam to present expert testimony to advance the mosaic defense. During the trial, Professor Gregg A. Jarrell, a former SEC chief economist, took the stand for two days. He presented his views to the jury with the assistance of a PowerPoint presentation that was several hundred pages long. Professor Jarrell addressed each stock that Rajaratnam was accused of trading on illegally and explained why

those trades were reasonable, based on piecing together a mosaic of publicly available information. Professor Jarrell further ended each presentation with regards to a particular company with an analysis of whether the alleged insider information created a statistically significant market effect, and summarized Rajaratnam's trades in that company's shares as a whole over time compared with the specific trades in question, showing how Rajaratnam and the market reacted to the different pieces of information. In this way, Professor Jarrell gave the jury a real basis to consider the mosaic defense to the insider trading charges.

In the end, the mosaic defense failed for Rajaratnam, not because it lacks viability as a defense, but because the wiretap evidence made it seem that Rajaratnam was more impressed with the tips he received than the legitimate research to which he had access, which the jury may well have concluded served to establish both the materiality of the inside information and the defendant's *scienter*. The materiality of this information was only reinforced by wiretapped statements argued to reflect consciousness of guilt.

The true test of the mosaic defense will await another day and another courtroom, in a case where the outcome is not driven by the unique facts presented in the *Rajaratnam* case.

## NOTES

<sup>1</sup> *United States v. Raj Rajaratnam*, 09 CR 1184 (RJH) (S.D.N.Y.).

<sup>2</sup> 1:08 CR 00415 (FB) (E.D.N.Y.).

<sup>3</sup> 438 U.S. 154 (1978).

<sup>4</sup> See Securities and Exchange Commission, Adopting Release for Regulation FD, Rel. No. 34-43154.