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Second Circuit Affirms Raj Rajaratnam Conviction; Addresses Important Issues of Law Regarding Wiretap Applications and Insider Trading Elements

On June 24, 2013, in a highly anticipated decision, the United States Court of Appeals for the Second Circuit affirmed the judgment of conviction against Galleon Group founder and former hedge fund manager Raj Rajaratnam. *See United States v. Rajaratnam*, 11-3316-cr (June 24, 2013) (available at http://www.ca2.uscourts.gov/decisions/isysquery/cd3bf970-c9eb-4684-8826-1716e0ca7c32/1/doc/11-4416_opn.pdf) (hereafter, "*Rajaratnam*").

The court's decision will no doubt encourage continued aggressive investigation of insider trading cases, and the use of court-ordered wiretaps to do so. The decision also serves as a stern warning to would-be insider traders that the mere knowing possession of material nonpublic information can result in criminal liability, even if the trader claims the material nonpublic information was not a factor in the trading decision.

THE SECOND CIRCUIT'S RULING REGARDING EVIDENCE OBTAINED BY WIRETAP

When the government seeks a wiretap pursuant to Title III of the Omnibus Crime Control and Safe Streets Act of 1968, 18 U.S.C. §§ 2510-2522, it must establish probable cause and necessity. The wiretap application must provide "a full and complete statement of the facts and circumstances relied upon by the applicant" to establish probable cause. *Id.* § 2518(1)(b). And to prove necessity, the application

must provide a "full and complete statement as to whether or not other investigative procedures have been tried and failed or why they reasonably appear to be unlikely to succeed if tried or to be too dangerous." *Id.* § 2518(1)(c). Rajaratnam challenged both probable cause and necessity, claiming the government misstated certain material facts and omitted others from its Title III wiretap application.

Under *Franks v. Delaware*, 438 U.S. 154 (1978), where a defendant makes a preliminary showing that the government's wiretap application misstated or omitted material information, the district court must hold a hearing to determine whether the alleged misstatements or omissions in the warrant or wiretap application were made intentionally or with "reckless disregard for the truth" and, if so, whether any such misstatements or omissions were "material." *United States v. Rajaratnam*, No. 09 Cr. 1184 (RJH), 2010 WL 4867402, at *7-8 (S.D.N.Y. Nov. 24, 2010). In other words, "[t]o suppress evidence obtained pursuant to an affidavit containing erroneous information, the defendant must show that: (1) the claimed inaccuracies or omissions are the result of the affiant's deliberate falsehood or reckless disregard for the truth; and (2) the alleged falsehoods or omissions were necessary to the [issuing] judge's probable cause [or necessity] finding." *United States v. Canfield*, 212 F.3d 713, 717-18 (2d Cir. 2000) (internal quotation marks omitted).

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As to probable cause, the Second Circuit held that, even if the government's Title III application contained misstatements, they were not material. *Rajaratnam* at 23-24. Regarding necessity, Rajaratnam claimed the government acted with a reckless disregard for the truth when it omitted from the application that the SEC had been conducting an investigation of Rajaratnam. That investigation included a deposition of Rajaratnam, the depositions of other Galleon employees, and the production of approximately four million documents, which were provided to federal prosecutors. According to Rajaratnam, the existence of the SEC investigation rendered the wiretap unnecessary, and therefore, the government should have included information about the SEC investigation in the wiretap application.

The District Court held that "Rajaratnam must prove that the drafters of the affidavit [supporting the Title III wiretap application] either intentionally omitted information or that the omitted information was clearly critical to the affidavit, thereby raising an inference of recklessness." *United States v. Rajaratnam*, 2010 WL 4867402, at *9. Based on this standard, and the District Court's belief that the existence of the SEC investigation was "clearly critical," the District Court concluded that the government's omission of the SEC investigation was made with a reckless disregard for the truth. *Rajaratnam* at 14. But the Second Circuit held that this was the incorrect standard because it failed to take into account the "actual states of mind" of the applicants. *Id.* at 19-20.

Rather, the Second Circuit stated that "[a] wiretap applicant does not necessarily act with 'reckless disregard for the truth' simply because he or she omits certain evidence

that a reviewing court, in its judgment, considers to be 'clearly critical.' Rather, the reviewing court must be presented with credible and probative evidence that the omission of information in a wiretap application was 'designed to mislead' or was 'made in reckless disregard of whether [it] would mislead.'" *Id.* at 20 (citations omitted). Sometimes, the court said, a reckless disregard of whether omissions will mislead the reviewing court can be inferred from the omission of critical information, but that inference is not automatic. "[A]nd the inference is particularly inappropriate where the government comes forward with evidence indicating that the omission resulted from nothing more than negligence, or that the omission was the result of a considered and reasonable judgment that the information was not necessary to the wiretap application." *Id.* at 21.

The Second Circuit held that such an inference could not be drawn in Rajaratnam's case because none of the affiants supporting the Title III application subjectively acted with reckless disregard for the truth by trying to mislead the reviewing court or by recklessly disregarding the possibility of misleading the reviewing court. They simply did not believe the omitted information was necessary for the wiretap application or they did not think about including the omitted information. Moreover, the Second Circuit noted, adding information regarding the SEC investigation would only have strengthened the application. It would have shown that more traditional investigative methods – such as depositions and document requests – did not disclose important information necessary in an insider trading investigation because that information was often exchanged by telephone. *Id.* at 22. Lastly,

the Second Circuit agreed with the District Court that, even if the omissions at issue were made with a reckless disregard for the truth, the omissions were not material. *Id.* at 23.

The Second Circuit's standard for reviewing omissions from wiretap applications should cause some concern for defendants and targets of government investigations. It allows wiretap applicants to omit potentially important – even "critical" – information as long as the applicants are not subjectively intending to mislead, or subjectively disregarding the possibility of misleading, the reviewing court. This standard gives the government significant leeway in deciding what information to include in applications. Perhaps more importantly, it makes any challenge to an application particularly difficult to win. Not only does a defendant have to prove that certain information was omitted, but it has to prove the state of mind of the applicants. Rarely will a defendant have direct evidence that a government agent intended to mislead a reviewing court, and proving intent or even reckless disregard for the truth will be difficult with circumstantial evidence. The government will almost certainly come forward with contrary evidence showing that the applicants acted subjectively with good faith. The Second Circuit's *Rajaratnam* decision will therefore do nothing to slow down the government's aggressive use of wiretaps in white collar investigations.

THE SECOND CIRCUIT'S RULING ON THE "KNOWING POSSESSION" ELEMENT OF INSIDER TRADING

The other significant portion of the Second Circuit's decision related to the "in connection with" element of an

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insider trading violation. In pertinent part, the securities laws prohibit fraudulent, manipulative or deceptive practices “in connection with” the purchase or sale of any security. *Rajaratnam* at 25 n. 22 (citing 15 U.S.C. § 78j and 17 C.F.R. § 240.10b-5). Trading on material nonpublic information is a fraudulent, manipulative or deceptive practice. At issue in *Rajaratnam* was whether the government could prove the “in connection with” element by showing “knowing possession” of material nonpublic information at the time a trade was made, or whether the government had to prove some causal connection between the information and the reason for making the trade.

The District Court instructed the jury that “it could convict Rajaratnam if the ‘material non-public information given to the defendant was a factor, however small, in the defendant’s decision to purchase or sell stock.’” *Id.* at 24. The Second Circuit held that this instruction was appropriate. The court said a number of factors weigh in favor of a “knowing possession” standard, including that: the securities laws require only that a deceptive practice be conducted in connection with the purchase or sale of a security; a knowing possession standard comports with the oft-quoted maxim that one with a fiduciary or similar duty to hold material nonpublic information in confidence must either disclose or abstain with regard to trading; and a knowing possession standard has the attribute of simplicity. *Id.* at 26 (citing *United States v. Teicher*, 987 F.2d 112, 120 (2d Cir. 1993)).

Moreover, the court noted that the District Court’s instruction — “a factor, however small” — was even more favorable to

Rajaratnam than “knowing possession.” The government can prove “knowing possession” simply by proving that a trader executed trades knowingly in possession of material nonpublic information, regardless of how that information influences the trader’s decision. But the District Court’s instruction in *Rajaratnam* required that the government prove the inside information was a “factor” in the decision to execute trades, even if it was a very small factor. *Id.* at 27.

This “knowing possession” standard, which has long been an element of insider trading cases, eviscerates a defendant’s argument that he did not rely upon the material nonpublic information he possessed when executing trades. Indeed, once the trader is in knowing possession of material nonpublic information, his hands are likely tied unless he wants to risk a violation of insider trading laws, and he should not execute a trade to which the information is relevant, even if he has other reasons to make the trade.

This standard also makes it difficult for defendants to rely on the so-called “mosaic theory” of trading once they possess material nonpublic information. The mosaic theory allows traders to piece together information from different sources to make a trading decision, but the “knowing possession” element undermines the mosaic theory if a piece of the mosaic — as small as it might be — is material nonpublic information. In sum, a trader in possession of material nonpublic information would be wise not to execute a trade relevant to that information even if he can point to other reasons he made the trade.

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