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Second Circuit rewrites the rules on insider trading

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In a split decision issued on August 23, 2017 in *United States v. Martoma*, No. 14-3599, 2017 U.S. App. LEXIS 16084 (2d Cir. Aug. 23, 2017), the Second Circuit overruled its own precedent in *United States v. Newman,* 773 F.3d 438 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015) and once again rewrote the law on insider trading. The Court of Appeals held that the "logic" of the United States Supreme Court's decision last year in *Salman v. United States*, 137 S. Ct. 420 (2016), "fundamentally altered" the analysis of insider trading so that *Newman* is "no longer good law." *Martoma*, 2017 U.S. App. LEXIS 16084, at *23-24.

In *Newman*, the Second Circuit held that an insider trading conviction based on the theory that a tipper received a personal benefit by giving a tip requires proof of "a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." *Newman*, 773 F.3d at 452.[1] This week, the Second Circuit eliminated its prior requirement of a "meaningfully close personal relationship" and held, instead, that an insider or tipper may be liable for insider trading whenever the tipper discloses inside information "with the expectation that [the recipient] would trade" because "such a disclosure is the functional equivalent of trading on the information himself and giving a cash gift to the recipient," regardless of the relationship between the tipper and the tippee. *Martoma*, 2017 U.S. App. LEXIS 16084, at *25. In a 44-page dissent, Judge Rosemary Pooler warns that the Court's decision will expand the scope of insider trading liability, undermining the objectivity and limitations established in Supreme Court precedents, and disputes the majority's interpretation of *Salman*. *Martoma*, 2017 U.S. App. LEXIS 16084, at *36-62.

Background

Mathew Martoma, a portfolio manager at S.A.C. Capital Advisors, LLC ("SAC"), was convicted of insider trading in the securities of two pharmaceutical companies that were jointly developing an experimental Alzheimer's drug. *Martoma*, 2017 U.S. App. LEXIS 16084, at *4-5. SAC retained as

[1] *See also,* Kelly, Brian T. "*United States v. Newman*: Second Circuit clarifies its "Delphic" interpretation of insider trading laws in landmark ruling." December 11, 2014, available at https://www.nixonpeabody.com/ideas/articles/2014/12/11/emunited-states-v-newmanem-second-circuit-clarifies-its-delphic-interpretation-of-insid.

consultants two doctors who were working on the clinical trials of the drug. In violation of their obligations to maintain the confidentiality of information about the trials, the consultants each disclosed significant non-public information to SAC. *Id*. at *6-7. One of the consultants provided Mr. Martoma with non-public information about the negative results of the trial in advance of his public presentation. Although the consultants were generally compensated by SAC for their time, SAC was not billed for these particular conversations.

Soon after receiving the non-public information, SAC began to reduce its long positions in the securities of the two companies, entering into short sales and options trades instead. When the final results from the clinical trials were publicly presented, the share prices of the companies' securities dropped precipitously. SAC realized $80.3M in gains and avoided $194.6M in losses, while Mr. Martoma received a $9M bonus based in large part on this trading activity. *Id*. at *8.

After Mr. Martoma's conviction, and while his appeal was pending, the Second Circuit issued its decision in *Newman* in 2014. The Supreme Court decision in *Salman* followed last year. On his appeal, Mr. Martoma challenged the sufficiency of the evidence presented at his trial as well as the jury instructions, which were based on the law prior to *Newman*. *Id*. at *12-14.

Discussion: The history of insider trading law and the personal benefit requirement

In its seminal 1983 decision in *Dirks v. S.E.C* [2], the Supreme Court held that a tippee's liability is derivative of a tipper's breach of a fiduciary duty occurring when the tipper reveals confidential information belonging to a third party for personal benefit. Courts have struggled with the definition and elements of the personal benefit requirement ever since. *Dirks* held that a personal benefit exists when the tipper receives a pecuniary gain or a reputational benefit, and that a personal benefit can also be inferred where the tipper gives the information to "a trading relative or friend" because "[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient." *Dirks*, 463 U.S. at 664.

In *Newman*, the Second Circuit held that such an inference of a "gift" sufficient to constitute a personal benefit requires proof of "a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." *Newman*, 773 F.3d at 452. Eighteen months later, in *Salman*, a unanimous Supreme Court held that a family relationship among the various relatives in that case was sufficient to establish a personal benefit, at least where the tipper intended his sibling and in-law to receive the gift of valuable inside information, all without requiring proof of any potential gain.[3] The Supreme Court mentioned *Newman*, noting that "[to] the extent the Second Circuit held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends, . . . this requirement is inconsistent with *Dirks*." *Salman*, 137 S. Ct. at 422.

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[2] *S.E.C. v. Dirks*, 463 U.S. 646 (1983).

[3] *See also* LaRose, Stephen et al. "Supreme Court finds that a family relationship is enough to establish the "tipper's benefit" necessary to prove a charge of insider trading" Dec. 6, 2016, *available at* https://www.nixonpeabody.com/-/media/Files/Alerts/2016%20December/Tippers-benefit-Salman-v-US-insider-trading-decision-06DEC16.ashx

Mr. Martoma argued that the jury in his case had not been properly charged because it had not been instructed that it must find the "meaningfully close personal relationship" that *Newman* requires. The Second Circuit concluded otherwise, relying upon the "logic" of the Supreme Court's reasoning in *Salman*, and held that *Newman's* requirement of a "meaningfully close personal relationship" to infer a personal benefit was no longer valid. *Martoma*, 2017 U.S. App. LEXIS 16084, at *23. [4]

It is not clear why the Second Circuit needed to reach this issue to uphold Mr. Martoma's conviction, given its conclusion that there was "compelling evidence" that the "tipping" doctor received a "pecuniary benefit" in the form of the consultant fees paid to him by Mr. Martoma's firm, SAC, sufficient to establish a *quid pro quo* relationship with opportunity for future potential gain, even though the doctor was not paid for the particular conversation in which the clinical trial results were disclosed. *Id*. at *19, 75-76. The Court could have stopped there, given its conclusion that any error—even obvious error—did not impair Mr. Martoma's substantial rights. *Id*. Nonetheless, for reasons that it did not explain, the Court went on to also address the jury instructions regarding a personal benefit based on a "gift" of inside information.

Relying heavily on the observation in *Salman* that an insider benefits because "giving a gift of [inside] information is the same thing as trading by the tipper followed by a gift of the proceeds," *Salman*, 137 S. Ct. at 428, the Second Circuit majority held in *Martoma* that there is no basis to distinguish between gifts to people with whom a tipper shares a meaningfully close personal relationship and gifts to those with whom the tipper has no relationship. In either context, if the insider discloses inside information "with the expectation that [the recipient] would trade on it," *Martoma*, 2017 U.S. App. LEXIS 16084, at *26 (quoting *Salman*, 137 S. Ct. at 428), the tipper benefits just as if he had received a gift from his tippee of the profits earned on the trade. In the view of the majority, the examples in *Dirks* of when a personal benefit could be inferred based on a gift were not exclusive or limiting, and the ultimate inquiry remains whether an insider tippee personally benefits, directly or indirectly. *Id*. at *28-29.

While noting that it was ordinarily not appropriate to reverse existing Circuit precedent, and while recognizing that the Supreme Court had not expressly rejected *Newman*'s requirement that the tipper and tippee have a "meaningfully close personal relationship" to justify an inference of a personal benefit, the majority in *Martoma* nonetheless concluded that nothing in *Salman* supported such a distinction based on the relationship of insider and trader. If an insider discloses information with "'the expectation that [the recipient] would trade on it' and the disclosure resemble[s] trading by the insider followed by a gift of the profits to the recipient'", the tipper has personally benefitted. *Id*. at *26, 27-28.

Rejecting the dissent's criticism that its decision would greatly expand insider trading liability, the majority noted that proof would still be required that an insider expected his or her tippee to trade on the information. That is, there would be no liability for the tipper or the tippee where the disclosure was made for other purposes, such as whistleblowing or journalistic efforts, or where the disclosure was inadvertent. *Id.* at *28.

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[4] The Second Circuit also concluded that, even though the consultant had not been paid for the conversation in which he disclosed inside information, the evidence of the payments he did receive established a *quid pro quo* relationship that was sufficient to constitute a personal benefit, and therefore, even if the jury instructions were obviously erroneous, that did not impair Mr. Martoma's rights. *Martoma*, 2017 U.S. App. LEXIS 16084, at *34-36.

Judge Pooler was not mollified by this explanation. Rather, she argued in her dissent that the Supreme Court had shown no disapproval in *Salman* of the *Newman* requirement of a "meaningfully close personal relationship," challenging only the requirement that an insider receive "something of a 'pecuniary or similarly valuable nature.'" *Id*. at *50-51. In her view, the decision will allow "juries and, more dangerously, prosecutors" to "seize on this vagueness and subjectivity" to pursue liability "in many cases where it could not previously lie." *Id*. at *37.

Significantly, both the majority and the dissent recognized that not all insider trading is illegal, and that ethics and the law are not coterminous, but the majority is creating a rule that the "legality of insider trading is coextensive with a corporate insider's fiduciary duty of loyalty to the corporation (citing *Dirks*)." *Id*. at *34, 78.

What comes next?

Pundits have questioned whether the *Martoma* decision will be subject to further review, either *en banc* at the Second Circuit or by the Supreme Court. The Second Circuit grants *en banc* review in few cases, but it also rarely reverses itself, so there is a somewhat greater chance that Mr. Martoma will garner the six votes needed to obtain *en banc* review in this instance. If there is no *en banc* review, it seems somewhat unlikely that the Supreme Court would grant *certiorari*. It declined to do so in *Newman*, and there is no split among the circuits presently.

The *Martoma* decision again underscores the lack of bright lines of the boundaries of potential criminal and civil liability for insider trading where information is given to a tippee without a direct monetary payment. The questions are now even more unsettled where the parties have an attenuated relationship. Until the Supreme Court addresses the issue again, the only certainty is that the debate will continue.

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