

Litigation Alert

August 24, 2017

Key Points

- A divided 2nd Circuit holds that there is no requirement for a “meaningfully close personal relationship” between a tipper and tippee in order for the tipper to reap a personal benefit from the disclosure sufficient to give rise to criminal liability for insider trading, regardless of whether the parties otherwise qualify as relatives or friends.
- The opinion announces the abrogation of a key aspect of the 2nd Circuit’s earlier decision in *United States v. Newman*, presenting the possibility of substantially broader liability in tipping cases.
- The dissent argues that the majority misreads the Supreme Court’s decision in *Salman v. United States*, raising the possibility of *en banc* review or, at some point, further consideration of the issue by the Supreme Court.



U.S. v. Martoma: The Second Circuit Reconsiders the Personal Benefit Rule in Insider Trading Cases and Announces the Partial Abrogation of Newman

This week, in an opinion by Chief Judge Robert A. Katzmann that was joined by Circuit Judge Denny Chin, the 2nd Circuit affirmed the insider trading conviction of former SAC Capital Advisors LP manager Mathew Martoma. No. 14-3599 (2d Cir. Aug. 23, 2017). In a 2-1 opinion, the court held that the Supreme Court’s 2016 decision in *Salman v. United States*, 137 S. Ct. 420 (2016) abrogated the requirement for a “meaningfully close personal relationship” between tipper and tippee previously articulated by the 2nd Circuit in *United States v. Newman*, 773 F.3d 438 (2014). The majority did not disturb *Newman*’s other key holding—which is consistent with language in the *Salman* opinion—that at least in a criminal case, the government must prove that the tippee **knew** that the tipper breached a duty and received a personal benefit in order to be liable for insider trading. Judge Rosemary S. Pooler, who wrote separately, dissented.

Background

In *Newman*, the 2nd Circuit held that, in order to infer a personal benefit to the tipper from a gift of confidential information to a trading relative or friend, a jury must find that there is “proof of a meaningfully close personal relationship” between tipper and tippee “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. In *Salman*, the Supreme Court pared back one aspect of *Newman*, unanimously holding that the government is not necessarily required to prove that tippers receive a concrete, pecuniary benefit in exchange for their tips; rather, liability can be established if a tipper provides inside information as a gift to a trading relative or friend. 137 S. Ct. 420 (2016). In *Martoma*, the 2nd Circuit held that *Salman* effectively overruled *Newman*'s requirement of a "meaningfully close personal relationship" between the tipper and tippee. Under *Martoma*, the key questions are: (1) whether the tipper had an expectation that his tippee would trade on the inside information; and (2) whether the disclosure "resembles trading by the insider followed by a gift of the profits to the recipient." Slip Op. at 27-28.

Martoma, a former portfolio manager at SAC Capital, was responsible for managing \$400 to 500 million in pharmaceutical and health care industry investments. In an effort to obtain information about an experimental Alzheimer's drug, Martoma obtained information from paid consultants, including two doctors who were working on the drug's clinical trial. Both doctors were obligated to maintain the confidentiality of the trial results, but they communicated with Martoma dozens of times and disclosed confidential information about the drug's safety and trial results. Directly following one such meeting, Martoma began reducing SAC's position in the companies developing the experimental drug. Shortly thereafter, one of the doctors presented the final results of the drug trial at an industry conference, at which time, the drug companies' share prices dropped significantly. Martoma's trades ahead of the presentation earned SAC approximately \$80 million in profits and helped avoid close to \$195 million in losses. Martoma received a \$9 million bonus from SAC, in part, based on the performance of his investment in these drug companies.

Martoma was convicted in February 2014, prior to the decisions in either *Newman* or *Salman*. On appeal, he argued that, in light of *Newman*, the evidence presented at his trial was insufficient to support a conviction and that the district court's jury instructions were flawed because they permitted conviction without proof of a "meaningfully close personal relationship" with the doctor who provided the information, which was required under *Newman* in order to satisfy the "personal benefit" requirement.

After the 2nd Circuit heard oral argument in Martoma's appeal, the Supreme Court issued its **decision** in *Salman v. United States*. In *Salman*, the Court "adhere[d] to *Dirks*," the seminal 1983 decision that established the framework for tipper-tippee liability, holding that a jury may infer a personal benefit when a tipper provides inside information to a relative or friend. *Salman*, 137 S. Ct. at 427 (discussing *Dirks v. SEC*, 463 U.S. 646 (1983)). Referring to *Newman*, the Court stated, "[t]o the extent the 2nd 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*." *Id.* at 428.

The majority (Judges Katzmann and Chin) held that Martoma's "ongoing 'relationship of *quid pro quo*'" with the tipping doctor justified conviction under a pecuniary theory, even though the doctor did not bill Martoma specifically for his pre-conference meetings. Slip Op. at 17-18. But the court did not stop there,

proceeding to address *Martoma*'s other claims under the standards for gift theory articulated in *Dirks*, *Newman* and *Salman*.

The majority observed that the logic of *Salman* precluded it from applying *Newman*'s additional requirement for finding a "meaningfully close personal relationship" in tipping scenarios that did not involve friends or relatives. Specifically, the majority found that "the straightforward logic of the gift-giving analysis" in *Salman* "[was] that a corporate insider personally benefits whenever he 'disclos[es] inside information as a gift . . . with the expectation that [the recipient] would trade' on the basis of such information or otherwise exploit it for his pecuniary gain" and "such a disclosure is the functional equivalent of trading on the information himself and giving a cash gift to the recipient," regardless of whether the tipper and tippee share a "meaningfully close personal relationship." *Id.* at 25. As the *Martoma* majority noted, this scenario is laid out clearly in the *Dirks* opinion itself. The *Martoma* court made clear, however, that the nature of the relationship between the tipper and tippee may be relevant to the jury's determination of whether the tipper had an expectation that the tippee would trade on his information, and to the related determination of whether the disclosure was equivalent to a gift of the trading proceeds by the tipper. *Id.* at 28, n. 8. The court insisted that its ruling "does not eliminate or vitiate the personal benefit rule," but rather "acknowledge[d] that it [was] possible to personally benefit from a disclosure of inside information as a gift to someone with whom one does not share a 'meaningfully close personal relationship.'" *Id.* at 29-30.

Writing separately in a lengthy dissent, Judge Rosemary S. Pooler stated that the majority's ruling "holds that an insider receives a personal benefit when the insider gives inside information as a 'gift' to any person," and thus, strips the "personal benefit rule of its limiting power." *Id.* at 2 (J. Pooler, dissenting). Judge Pooler maintained that *Salman* overturned only the 2nd portion of *Newman*'s holding, which imposed additional requirements for demonstrating personal benefit in circumstances involving tips to relatives or friends, and left intact *Newman*'s first holding, which required proof of a "meaningfully close personal relationship" to support a finding of personal benefit where the tippee was not a relative or friend. *Id.* at 15. Judge Pooler also criticized the *Martoma* panel for overruling *Newman* without going through the process of *en banc* review. *Id.* at 1.

Judge Pooler lamented the loss of the limiting principles of the personal benefit rule, as laid out in *Newman* (and *Dirks* and *Salman*), and wrote that the majority's focus on a tipper's expectation that the tippee will trade on the information merely restated an existing requirement for insider trading liability and "[did] not add a new limitation to replace the personal benefit rule." *Id.* at 20.

Implications of *Martoma*

By eliminating the need to show either friendship, a familial relationship, or another sort of close personal relationship between a tipper and tippee in a gifting scenario, the majority's opinion will likely expand the scope of tipping scenarios that could result in investigation and prosecution for insider trading. In this

respect, it was not surprising to see that representatives of the U.S. Attorney's Office for the Southern District of New York were pleased with the result.

However, going all the way back to *Dirks* itself, the development of the law in tipper-tippee cases has been circuitous and complex. Accordingly, it is fair to wonder whether *Martoma* is the last word or whether the 2nd Circuit will revisit the issue via *en banc* review. It is also possible that the Supreme Court might take up the question, although that seems unlikely in the absence of a circuit split.

Despite the intricate nuances of the law in this area, we remain of the view—as has been the case for many years—that from a risk-avoidance perspective, compliance professionals should take a conservative view and should counsel against trading in a scenario that involves the possession of material non-public information, at least without extremely careful analysis of questions of duties, motivations and personal benefit.

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