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Divided Second Circuit Broadens Personal Benefit Test for Insider Trading Liability

The court's* Martoma *decision reinvigorates the US government's ability to prosecute insider trading cases.

Key Points:

- The majority opinion overrules recent case law requiring that an insider have a meaningfully close relationship with a tippee and receive an objective and consequential benefit, while leaving intact the separate requirement that a tippee know of the personal benefit to the insider.
- A vigorous dissent warns of the government's potentially overbroad application of insider trading authority.
- The decision should serve as a reminder to company insiders and market professionals that any discussion involving confidential company information can lead to a lengthy and intrusive insider trading investigation.

On August 23, 2017, the Second Circuit issued its second significant decision on insider trading liability in the past three years, *United States v. Martoma*. In its 2014 decision in *United States v. Newman*, the Second Circuit limited the circumstances in which the government could prove insider trading on evidence that someone privy to inside information (a tipper) passed that information to another person (a tippee) who then traded on the information. Last year, the US Supreme Court's decision in *United States v. Salman* called into doubt some of the limits imposed in *Newman*, but the scope of the Court's curtailment was uncertain at that time. While *Martoma* certainly leaves important questions unanswered, the decision will reinvigorate the ability of the Department of Justice and the Securities and Exchange Commission (SEC) to pursue insider trading cases based on a wide variety of relationships and interactions between insiders and tippees.

A Brief History of the Personal Benefit Requirement

At issue in each of these recent landmark insider trading cases was the question of what evidence is necessary to establish that an insider who passed information to a tippee benefited personally from passing that information, such that the insider can be found to have breached a fiduciary duty or similar duty of trust and confidence as a result of the disclosure. The personal benefit requirement traces its roots to *Dirks v. SEC*, in which the Supreme Court articulated two prongs for establishing insider trading liability by a tippee privy to information from a corporate insider.[1] The test requires first that the tippee knew or should have known that the insider breached his or her fiduciary duty to shareholders by disclosing information to the tippee, and second, that the insider personally benefited, directly or indirectly, from the disclosure.[2] The Supreme Court explained that the latter inquiry "requires courts to focus on objective criteria, *i.e.*, whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings."[3] The Supreme Court further elaborated that certain objective facts and circumstances could justify an inference of personal benefit, such as "a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient," or "when an insider makes a gift of confidential information to a trading relative or friend."[4]

Suffice it to say, the SEC staff were unhappy with the *Dirks* decision and its focus on motive, as measured by pecuniary benefit. In the intervening decades, the SEC has continued to bring insider trading cases where the alleged benefit was less easily quantifiable than in the type of cash or similar quid pro quo transaction seen frequently in other kinds of fraud cases.[5] In 1990, Professor John Coffee, noting the SEC's reluctance to accept the apparent limits of *Dirks*, quoted an unnamed former SEC staff member as saying, "The SEC distinguishes *Dirks* in this way: they say 'is your name Dirks? If not, that decision does not apply to you.'"[6]

In addition to continuing to pursue tipping cases charging a broad range of non-monetary benefits, 17 years after *Dirks*, the SEC enacted Regulation FD and broadened who could be charged for disclosing material non-public information. Regulation FD generally prohibits intentional selective disclosure of material non-public information to market professionals and to security holders under circumstances in which it is reasonably foreseeable that the holder will trade on the basis of the information. In the event of unintentional disclosure, an issuer must promptly disseminate the material information. Regulation FD was adopted not under the antifraud provisions of the Exchange Act, but under the reporting requirements of Section 13, and it does not require a showing of benefit to the person making the improper disclosure.[7] For its part, the Department of Justice has been aggressive in advancing the types of conduct that meet the *Dirks* personal benefit test in recent years. *Newman*, *Salman*, and *Martoma* are all products of increased criminal focus on insider trading that includes tippees.

In the *Newman* decision, the Second Circuit appeared to restrict the circumstances in which the government could establish the personal benefit component of *Dirks*, holding that the inference of a personal benefit is "impermissible in the absence of 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."[8] The court noted that the government could not establish a personal benefit "by the mere fact of a friendship, particularly of a casual or social nature."[9] *Newman* also announced a more stringent requirement for the benefits to the tippee that would satisfy the personal benefit, noting that the benefits must be "objective, consequential and represent at least a potential gain of pecuniary or similarly valuable nature," suggesting that the benefit had to be either tangible or, if intangible, very clearly defined. Finally, the Second Circuit in *Newman* refined the knowledge requirement of *Dirks*, concluding that "a tippee's knowledge of the insider's breach necessarily requires knowledge that the insider disclosed confidential information in exchange for personal benefit."[10]

While the Supreme Court declined to grant certiorari in *Newman*, in *Salman v. United States*, the Court unanimously reaffirmed *Dirks*' articulation of the personal benefit prong and seemed to reject the more constrained reading advanced in *Newman*. The Supreme Court reiterated that the existence of a personal benefit turns on "whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputation benefit that will translate into future earnings."[11] The Supreme Court also noted that "a jury can infer a personal benefit — and thus a breach of the tipper's duty — where the tipper receives something of value in exchange for the tip or 'makes a gift of confidential information to a trading relative or friend.'"[12] Addressing *Newman*, the Supreme Court stated that the Second Circuit's holding "that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends ... [was] inconsistent with *Dirks*."[13]

Given the relationship of the tipper and tippee as brothers in *Salman* (defendant was the tippee's friend and tipper's brother-in-law), the Supreme Court did not have reason to address *Newman*'s requirement that the tippee and the insider share a "meaningfully close personal relationship." The Court did, however, acknowledge the government's argument that a gift of confidential information to *anyone*, not just a relative or close friend, could be enough to establish a personal benefit.[14]

The Second Circuit's decision in *Martoma* has now addressed the question of whether a personal benefit can be established based on a gift of confidential information to "anyone," as the Second Circuit held that the logic of *Salman* abrogated *Newman*'s "meaningfully close personal relationship" requirement.[15]

The Majority Opinion in *Martoma* Cabins *Newman*

Defendant Mathew Martoma managed a pharmaceutical and healthcare portfolio for a prominent hedge fund.[16] During his time there, Martoma began to acquire shares in two pharmaceutical companies, which were jointly developing a drug to treat Alzheimer's Disease.[17] In order to obtain information about the drug, Martoma used an expert networking firm to set up paid consultations with doctors involved with the clinical trial for the drug, who were obligated to keep the results of the trial confidential.[18] Martoma then traded based on information he learned during those consultations and passed that same information to a senior fund manager, who did the same.[19] Those trades resulted in US$80.3 million in gains and US$194.6 million in averted losses for the hedge fund, as well as a large personal bonus for Martoma.[20]

Martoma was eventually indicted for his role in the alleged insider trading scheme and, following a four-week jury trial, was convicted of one count of conspiracy to commit securities fraud in violation of 18 U.S.C. § 371 and two counts of securities fraud in violation of 15 U.S.C. §§ 78j(b) and 78ff.[21] Martoma appealed his conviction to the Second Circuit, arguing that the evidence the government presented at trial was insufficient to support his conviction and that the district court had failed to instruct the jury properly in light of the Second Circuit's decision in *Newman*.[22]

Before the Second Circuit, Martoma attempted to avail himself of the opening arguably left by *Salman*, asserting that because he and a doctor involved in the clinical trial did not enjoy a meaningfully close relationship, there was insufficient evidence of a personal benefit.[23] Indeed, *Dirks* acknowledged that "[i]mposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market."[24]

The Second Circuit rejected Martoma's argument, however, holding that "an insider or tipper personally benefits from a disclosure of inside information whenever the information was disclosed with the expectation that the recipient would trade on it ... and the disclosure resembles trading by the insider followed by a gift of the profits to the recipient ... whether or not there was a meaningfully close personal relationship between the tipper and tippee."[25] The majority (Chief Judge Robert Katzmann and Judge Denny Chin) explained that "it is critical to keep in mind that the ultimate inquiry under *Dirks* is whether a tipper has personally benefitted from a disclosure of inside information such that he has violated his fiduciary duty, and it is not apparent that the examples in *Dirks* support a categorical rule that an insider can never benefit personally from gifting inside information to people other than 'meaningfully close' friends or family members."[26]

Citing the Supreme Court's decision in *Salman,* the *Martoma* majority took the unusual step of reversing the Second Circuit's prior holding in *Newman* that a tipper must have a "meaningfully close personal relationship" with the tippee to justify the inference of a personal benefit.[27] The majority found that nothing in *Salman*'s strong reaffirmation of *Dirks* — "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" — supported a distinction between gifts of information made to close friends and family members and those made to other individuals.[28]

The *Martoma* majority was careful to note that not all disclosures of inside information will necessarily meet this test, and that in some scenarios the facts will not justify an inference that information was disclosed "with the expectation that [the recipient] would trade on it ... and that the disclosure resemble[s] trading by the insider followed by a gift of the profits to the recipient."[29] Thus, the majority maintained that its holding in *Martoma* merely reflects the possibility that a personal benefit may be derived from a gift of information to individuals other than close friends and family members, and thus does not vitiate the personal benefit requirement entirely.[30]

Notably, the *Martoma* majority did not reach the other significant aspect of *Newman*'s holding: that a tippee must have *knowledge* that the insider's disclosure of confidential information was for the specific purpose of obtaining a personal benefit. This may remain an avenue for an alleged tippee defendant to challenge the adequacy of the government's proof that he or she should be held liable for securities fraud.

The Pooler Dissent

The majority opinion in *Martoma* sparked a vigorous dissent from Judge Rosemary Pooler. In a lengthy opinion, she warned that, "[i]n holding that someone who gives a gift *always* receives a personal benefit from doing so, the majority strips the long-standing personal benefit rule of its limiting power."[31] Judge Pooler cautioned that the majority's conception of what constitutes a "gift" is both subjective and vague, and could result in liability in many cases where courts could not previously find it.[32] Judge Pooler read *Dirks* as having cabined liability based on gift-giving to situations in which the recipient was a family member or friend, a limitation *Newman* elaborated upon and *Salman* left undisturbed.[33] Judge Pooler noted that the majority's opinion went further than *Salman*, in which the Supreme Court had in fact considered — and declined to adopt — the government's position that "a gift of confidential information to anyone, not just a 'trading relative or friend,' is enough to prove securities fraud."[34]

Implications of *Martoma*

In light of Judge Pooler's dissent and the tension it highlights between the *Newman* and *Martoma* decisions, Martoma's case may be a candidate for *en banc* review by the full Second Circuit, though the Second Circuit rarely grants such review.[35] Indeed, Martoma may argue that the majority went too far in eliminating important restrictions on what constitutes unlawful sharing of information in the absence of a financial benefit, essentially eviscerating the personal benefit requirement.

Provided that the *Martoma* opinion withstands such arguments, future defendants may look to other limiting principles to challenge tipper-tippee liability theories pursued by the government. First, the *Martoma* majority explicitly contemplated the possibility that there are disclosures of inside information that would fall outside of the personal benefit test because they were not made with the expectation that the recipient would trade on them. The Second Circuit cited as an example disclosures made for whistleblowing purposes. Future defendants may argue that other circumstances and relationships are also outside the ambit of the personal benefit test. The court's discussion in *Martoma* indicates that such determinations may necessarily require a fact-intensive inquiry.[36]

Second, as noted above, the *Martoma* opinion left undisturbed *Newman's* requirement that the tippee possess *knowledge* that the insider disclosed confidential information for the specific purpose of obtaining a personal benefit. Defendants may seek further limits on the types of facts that will support an inference that a tippee *knew* that an insider sought to benefit from the disclosure of information. Among the important questions left unanswered is whether the same evidence that supports the inference that the insider would benefit from the disclosure can, by itself, also support an inference that the tippee knew of the benefit, or whether the knowledge component instead requires something more. This requirement is significant in the context of hedge funds and other asset managers, where a recipient of information may be uncertain as to its source. For example, like the facts in *Newman*, if the source of the information is several levels away from the person who actually made the trade, then whether or not the downstream tippee knew that the information was disclosed for a personal benefit will be an important factor in defending against any charges.

Periodically there are calls for Congress to provide a legislative definition of insider trading, similar to that found in other countries. Following the decision in *Newman*, legislation was proposed in both the House and the Senate that would have broadened the federal securities laws to prohibit almost any trading on confidential information.[37] Neither bill went forward. Earlier this year, Southern District of New York Judge Jed Rakoff, who has written a number of significant opinions on federal securities law issues, including the Ninth Circuit's opinion in *Salman* (for which he sat by designation), renewed the call for legislation, saying, "The United States, by failing to recognize, unlike most other developed countries, that a meaningful effective straightforward, simple ban on insider trading is best achieved through statute rather than judge-made law, has created unnecessary uncertainty and difficulty in dealing with the problem of insider trading."[38] The SEC has traditionally been lukewarm to such efforts, believing that legislation would unnecessarily limit its enforcement efforts. The agency's view seems unlikely to change anytime soon. Speaking at a New York University School of Law forum this month, new SEC Chairman Jay Clayton touted the US approach to confronting unlawful insider trading, which cases such as *Dirks*, *Newman*, *Salman*, and now *Martoma* endeavor to define. Responding to an audience question asking whether Congress should pass legislation addressing the issue, Clayton explained, "Some places that have a code-based insider-trading regime, my sense is [that] it doesn't work any better and in fact it's probably not as effective as our regime."[39] Given the Chairman's stance on the efficacy of the current system, it appears that, for now at least, the fact-intensive nature of these cases will ensure that the government and defendants will both continue to probe the outer limits of the various rules articulated by the courts in this continually developing area of law.

Beyond securities fraud, the *Martoma* court's holding may also impact insider trading enforcement in the commodities markets. Using authority enacted pursuant to the Dodd-Frank Act, the Commodity Futures Trading Commission (CFTC) recently brought its first two insider trading actions based on misappropriation of confidential information.[40] In promulgating the rule at issue in those actions, Rule 180.1, the CFTC stated that cases applying the comparable language of SEC Rule 10b-5 would guide its application.[41] The Second Circuit's clarification of the personal benefit requirement may speed the CFTC on a path to applying its insider trading authority to tipper-tippee cases like those pursued by the SEC.

Conclusion

The principal significance of *Martoma* is its abandonment of *Newman*'s "meaningfully close personal relationship" test and its shift to a test focused on whether the information "was disclosed with the expectation that the recipient would trade on it and the disclosure resembles trading by the insider followed by a gift of the profits to the recipient."[42] The decision serves as an important reminder (as if one was necessary) of the aggressiveness of the Department of Justice and the SEC in bringing cases that charge tipping.

Martoma is also a reminder that financial institutions and other market participants must take care in dealing with expert networks, such as the arrangement between Martoma and the research physicians alleged to have tipped him. For public company executives and directors, and those who counsel them, the case is also an important reminder that even the most casual discussion about confidential company information could lead to a lengthy and intrusive insider trading investigation.

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Endnotes

[1] The Court recognized that, "[n]ot only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain." *Dirks v. Securities and Exchange Commission*, 463 U.S. 646, 659 (1983).

[2] *Id.* at 660, 662.

[3] *Id.* at 663.

[4] *Id.* at 664.

[5] *See, e.g.*, Brief for the Securities and Exchange Commission as Amicus Curiae Supporting the Petition of the United States for Rehearing or Rehearing *En Banc* at 12-13, *United States v. Newman*, No. 13-1837 (2d Cir. Jan. 29, 2015) (No. 298) (collecting cases).

[6] John C. Coffee, Jr., *The SEC and the Securities Analyst*, N.Y.L.J., May 30, 1991, at 5.

[7] *Selective Disclosure and Insider Trading,* Securities Act Release No. 7881 (Aug.15, 2000). Regulation FD was enacted pursuant to Section 13 of the Exchange Act (not an antifraud provision) and the adopting release makes clear that selective disclosure on its own is not fraud.

[8] *United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014).

[9] *Id.*

[10] *Id.* at 449.

[11] *Salman v. United States*, 137 S. Ct. 420, 427 (2016).

[12] *Id.* at 423.

[13] *Id.* at 428.

[14] *Id.* at 426-27.

[15] *United States v. Martoma*, No. 14-3599, 2017 WL 3611518, at *1 (2d Cir. Aug. 23, 2017).

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] *Id.* at **1-2.

[20] *Id.* at *2.

[21] *Id.* at *1.

[22] *Id.*

[23] *Id.* at *4.

[24] *Dirks*, 463 U.S. at 658.

[25] *Martoma*, 2017 WL 3611518, at *8 (internal citations, quotation marks and alterations omitted).

[26] *Id.* at *7.

[27] *Id.*

[28] *Id.* at *8.

[29] *Id.* at *9.

[30] *Id.*

[31] *Id.* at *11 (Pooler, J., dissenting) (emphasis in original).

[32] *Id.* (Pooler, J., dissenting).

[33] *Id.* (Pooler, J., dissenting).

[34] *Id.* at *22 (Pooler, J., dissenting) (quoting *Salman*, 137 S. Ct. at 426).

[35] While the Second Circuit does not keep official statistics on rehearings *en banc*, our research indicates that the Court has only granted rehearing *en banc* ten times since 2000, and twice in the past five years. *See Poventud v. City of New York*, 750 F.3d 121 (2d Cir. 2014); *United States v. Ganias*, 824 F.3d 199 (2d Cir. 2016).

[36] For example, the Court noted that a disclosure of information to a reporter could fall on either side of the line depending on the facts and circumstances surrounding the tipper's relationship and prior dealings with the reporter. *Martoma*, 2017 WL 3611518, at *8 n.8.

[37] Peter J. Henning, *Court Strikes on Insider Trading, and Congress Lobs Back*, N.Y. TIMES (Mar. 16, 2015), https://www.nytimes.com/2015/03/17/business/dealbook/court-strikes-on-insider-trading-and-congress-lobs-back.html?mcubz=1&_r=0.

[38] Carmen Germaine, *Rakoff Urges Securities Bar to Write Insider Trading Law*, LAW360 (Mar. 1, 2017), https://www.law360.com/articles/897188/rakoff-urges-securities-bar-to-write-insider-trading-law

[39] Dave Michaels, *No Law Needed on Insider Trading, SEC Chief Says*, WALL ST. J. (Sept. 6, 2017), https://www.wsj.com/articles/no-law-needed-on-insider-trading-sec-chief-says-1504733816?cx_testId=16&cx_testVariant=cx&cx_artPos=0&cx_tag=collabctx&cx_navSource=newsReel#cxrecs_s.

[40] *In re Motazedi*, CFTC No. 16-02 (Dec. 2, 2015) (imposing $316,000 in sanctions for trading oil and gas futures using confidential information about employer's trades); *In re Ruggles*, CFTC No. 16-34 (Sept. 29, 2016) (imposing $5.25 million in sanctions for misappropriating employer's confidential information to benefit personal trading in oil and gas futures and options).

[41] 17 C.F.R. § 180.1; *Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation*, 76 Fed. Reg. 41,398, 41,407 (July 14, 2011).

[42] *Martoma*, 2017 WL 3611518, at *8 (internal citations, quotation marks and alterations omitted).