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Second Circuit Majority in *U.S. v. Martoma* Eliminates Proof of Financial or Other Personal Benefits to Tipper for Conviction

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On Aug. 23, 2017, the United States Court of Appeals for the Second Circuit issued a split decision in *United States v. Martoma*,[1] upholding a portfolio manager's insider trading conviction and finding that a tippee need not have a "meaningfully close personal relationship" with a tipper to be found guilty. The majority held that as long as a tipper gives material nonpublic information with an expectation the tippee will trade on it, the Supreme Court's personal benefit test is met. The majority found that the Supreme Court's *Salman*[2] decision at the end of last year implicitly overturned one of the central holdings in the Second Circuit's *Newman* decision,[3] which established the meaningfully close personal relationship element. In a lengthy dissent, Judge Rosemary S. Pooler argued that the majority's opinion was an expansion of the Supreme Court's *Salman and Dirks*[4] decisions, which she reasoned held that the "personal benefit" is satisfied without any other form of financial or nonfinancial benefit to the tipper only when the tippee is a close friend or relative. The removal of such requirement is a significant victory for the government's efforts to prosecute insider trading cases. Yet given the dissent, it is likely that Martoma will appeal for a Second Circuit *en banc* hearing or seek certiorari before the Supreme Court. As explained below, we anticipate the majority's opinion in *Martoma* will be overturned.

Background

According to the record, Mathew Martoma was a portfolio manager for one of the world's largest hedge funds, SAC Capital (SAC), run by Steven Cohen. One of Martoma's portfolios invested in healthcare and pharmaceutical companies, and Martoma also advised Cohen on trades for certain other funds Cohen oversaw. Martoma invested (and recommended Cohen similarly invest) in two companies, Elan Corporation, plc (Elan) and Wyeth, which created and oversaw testing on a new drug to treat Alzheimer's disease. Martoma engaged expert networking firms and arranged paid meetings with doctors associated with the drug's testing. Two of these doctors were working on the drug's clinical trials, and SAC, through the networking firms, paid each $1,000 to $1,500 per hour to discuss the drug and its testing.

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In July 2008, one of the doctors learned that the drug's efficacy was in doubt and called Martoma to discuss it. Martoma flew to meet the doctor, who gave Martoma this information, and then Martoma allegedly relayed it to Cohen. Martoma and SAC thereafter sold their Elan and Wyeth positions, shorted these stocks, and made options trades that would be profitable if the companies' shares fell. Two weeks later, the drug's test results were released, causing Elan's and Wyeth's stocks to fall. As a consequence, the trades Martoma and Cohen placed resulted in $80 million in gains and the avoidance of $195 million in losses. Martoma received a $9 million bonus that year, in large measure driven by these gains and avoided losses.

A jury convicted Martoma in 2014 of two counts of securities fraud in connection with an insider trading scheme and one count of conspiracy to commit securities fraud.

Prior decisional law

The Supreme Court affirmed tipping liability in *Dirks v. SEC*.[5] It held that when a tipper breaches a fiduciary duty by disclosing nonpublic information, a tippee can be found derivatively liable for the breach. Such a finding depends on "whether the [tipper] personally will benefit, directly or indirectly, from his disclosure."[6] It further held that "[a]bsent some personal gain, there has been no breach of duty to stockholders." Personal benefit includes the scenario under which "an insider makes a gift of confidential information to a trading relative or friend [because] the tip and trade resemble trading by the insider himself followed by a gift of profits to the recipient.[7]

The Second Circuit's *Newman* decision reestablished a barrier for prosecutors due to its arguably higher standard for tipping liability. That decision explored how a personal benefit may be inferred to the tipper, including in a situation where the tipper and tippee have a personal relationship; in such a scenario, money may not have been paid by the tippee to the tipper, and therefore it would be unclear how the tipper would benefit from divulging inside information to the tippee. *Newman* held that to allow an inference of personal benefit to the tipper "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] In light of this standard, the conviction of third- and fourth-level tippees with no knowledge of an insider's breach or personal benefit was overturned and the indictment dismissed.

In *Salman*, there was a tip by an insider to his brother. Relying on *Dirks*, the Supreme Court affirmed the conviction in the Ninth Circuit, stating that a tipper personally benefits by making a gift of confidential information to a "trading relative" without anything more.[9] Under these circumstances, the tipper benefits personally because giving a gift of trading information "is the same as trading by the tipper followed by a gift of the proceeds."[10] The insider here sought to provide the confidential inside information to his brother so that he could trade on it, and the tipper thus benefited personally. The Court found that "[t]o the extent the Second Circuit held that a 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*."[11]

Appellate argument and decision

Martoma initially argued on appeal that the jury was improperly instructed and there was insufficient evidence to convict under *Newman*. The Supreme Court handed down *Salman* during the appeal's pendency and Martoma argued that even under that decision "the government failed to prove the requisite 'personal benefit' to establish insider trading and the '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.'"[12]

Regarding personal benefit, the prosecution argued instead that "depth of a friendship – even assuming such a thing could be reliably determined – does not matter in this context; a disclosure is a breach of duty to one's principal whether made to a close friend or a distant one."[13]

The majority of the *Martoma* court found that a meaningfully close personal relationship was not a requirement in every case, including this one. It stated that "it is not apparent that . . . *Dirks* support[s] a categorical rule that an insider can never benefit personally from gifting inside information to people other than 'meaningfully close' friends or family members – especially because the justification for construing gifts as personal benefit is that '[t]he tip and trade resemble trading by the insider followed by a gift of the profits to the recipient.'"[14]

The majority was clear in its decision – "the straightforward logic of the gift-giving analysis in *Dirks*, strongly affirmed by *Salman*, is 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 pecuniary gain."[15]

The majority also provided a simple example that provides further rationale to its holding: An insider provides inside information about his company to his doorman in lieu of a year-end cash gift. The Court found that while "there may not be a 'meaningfully close personal relationship' between the tipper and tippee, . . . this clearly is an illustration of prohibited insider trading" because the tipper personally benefited from giving the tip, sparing himself the cash outlay to the doorman.[16]

In her dissent, Judge Pooler was adamant that the decision was wrong and harmful. "In 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. What counts as a 'gift' is vague and subjective. Juries, and, more dangerously, prosecutors, can now seize on this vagueness and subjectivity. The result will be liability in many cases where it could not previously lie."[17]

Pooler stated that *Salman* overturned only one of *Newman's* holdings: "an insider's gift to a friend only amounted to a personal benefit if the gift might yield money (or something similar) for the insider."[18] Pooler found that *Salman* did not reject *Newman's* "meaningfully close personal relationship" holding, however, because the Supreme Court "overruled *Newman* only *'[t]o the extent'* that it required an insider to 'receive something of a "pecuniary or similarly valuable nature" as a result of giving a gift to a friend. The Supreme Court's statement showed no disapproval of the

'meaningfully close personal relationship' language in *Newman*."[19] The majority countered the dissent's point that anyone who gives a gift always receives a personal benefit by noting that its holding "only reaches the insider who discloses the information to someone *he expects will trade on the information*."[20] In this sense, the majority simply "reject[ed], in light of *Salman*, the categorical rule that an insider can *never* personally benefit from disclosing inside information as a gift without a meaningfully close personal relationship."[21]

The dissent, however, remained highly concerned about the prosecutorial leeway given by the majority. As Pooler wrote, "in introducing the personal benefit rule in *Dirks*, the Supreme Court explained that it was 'essential . . . to have a guiding principle for those whose daily activities must be limited and instructed by the SEC's inside-trading rules,' and that without the personal benefit rule, there would be no such 'limiting principle' for insider trading."[22] She further quoted *Dirks*' warning: "Without legal limitations, market participants are forced to rely on the reasonableness of the SEC's litigation strategy, but that can be hazardous."[23]

Pooler also warned that the elimination of the personal benefit rule would give prosecutors too much power. Without the personal benefit criteria, many insider trading cases "would require the government to show few objective facts."[24]

The majority also stated that "not all insider trading cases rely on circumstantial evidence."[25] Pooler countered that such "observation will be cold comfort for defendants convicted based on circumstantial evidence alone. Rules of criminal liability should not rely on our hope that, in some cases, the government will present far more evidence than is required. We should instead be concerned with the minimum that the government must show to convict a criminal defendant."[26]

Pooler also noted that in the *Salman* case, "the government argued that a gift of confidential information to anyone, not just a trading relative or friend, is broad enough to prove securities fraud." The Supreme Court, however, "declined to adopt" this holding.[27] "Such a holding would have substantially broadened the rule in *Dirks*, which stated that a personal benefit may be inferred when an insider makes a gift of confidential information to a trading relative or friend. . . . The Supreme Court did not adopt the government's view, deciding instead to 'adhere to *Dirks*.'" [28]

As to the relationship between tipper and tippee, the majority stated that it still has importance in an insider trading case. According to the opinion, it is up to the jury "to evaluate competing narratives and decide what actually motivated the tipper to disclose confidential information, and consequently, whether there was a personal benefit to the insider on the facts of a particular case."[29]

Interestingly, as to the "meaningfully close" requirement, the majority left the door open on such considerations. The Court stated that it did "not hold that the relationship between the tipper and tippee cannot be relevant to the jury in assessing competing narratives as to whether information was disclosed with the expectation that [the recipient] would trade on it, . . . and whether the disclosure resemble[d] trading by the insider followed by a gift of the profits to the recipient."[30]

Takeaways

There are several points to consider following the *Martoma* decision:

1. The dissent provided important arguments for keeping in place the personal benefit element. Considering that many convicted insider trading defendants face both civil and criminal penalties, including incarceration, prosecuting solely on the basis of limited, subjective evidence may provide a dangerous overreach of prosecutorial power. An en banc Second Circuit panel or the Supreme Court may recognize Pooler's concern and overturn *Martoma.*

2. In all likelihood, the core holdings will be appealed *en banc* to the entire Second Circuit, and/or the defendant will seek certiorari to the Supreme Court. In either scenario, this decision may be temporary, and *Newman* may be restored.

3. The decision did not entirely eliminate the need to explore the relationship between tipper and tippee. Relationships will remain at the forefront of parties' arguments and defenses.

4. The majority's opinion's example of a tenant "gifting" inside information to the doorman presumes that the sharing of the information was in lieu of a year-end cash outlay, resulting in a personal benefit to the tipper. What is not explored is a scenario under which the tenant shared a tip with his doorman but still gave cash as a year-end gift. This scenario begs the question of whether the tenant tipper received a personal benefit. Under these facts, what would support a finding of a breach of fiduciary duty?

5. In *Martoma*, the tipper received a material amount of money (some $70,000)[31] in exchange for sharing information with the defendant. While the amount was not an express part of the decision, it would not be surprising to find that it made a difference in the majority's opinion. This made the result relatively straightforward and obviated the need to explore whether or not the relationship between tipper and tippee was meaningfully close. It remains an open question, in our view, whether culpability would have attached had Martoma paid the consultant only $5,000, $1,000 or $50. It seems there must, or should, be a materiality threshold to establish a personal benefit significant enough to send a defendant to prison.

6. Certain facts exist in this case that may allow the en banc panel or Supreme Court to agree with the majority decision but on somewhat different grounds. First, the tipper obtained a clear personal benefit by the significant consulting payments he received from SAC/Martoma, and he knew that Martoma was likely to trade on the information given. Second, there appears to be little question that Martoma was aware the doctor was in breach of his contractual and/or fiduciary obligations to the drug companies and consulting firm by providing the information to Martoma. Third, the doctor believed he and Martoma had, in the prosecutors' words, an "intimately personal" relationship. [32] The doctor explained at trial that "Martoma reminded him of his first son…."[33] While this was not directly discussed in the majority's decision, the combination of the significant monetary payment and Martoma being aware of the doctor's breach of duties may provide sufficient grounds upon which an appellate body may rely.

7. Irrespective of *Salman and Martoma*, if a case with the same facts as *Newman* were to now reach the Supreme Court, it is unlikely the result would be unchanged. The *Newman* tippees were three or four degrees removed from the tippers and did not know the tipper's breach, i.e., that the tippee knew that the information was confidential and divulged for a personal benefit. The further the tippee is from the source, the more difficult it is for culpability to attach. In our view, these recent decisions do not diminish the prosecutorial burden for cases involving remote tippees.

Endnotes

[1] *United States v. Martoma*, No. 14-3599, slip op. (2d Cir. Aug. 23, 2017).
[2] *Salman v. United States*, 137 S.Ct. 420 (2016). For a fulsome discussion of *Salman*, please see Marc D. Powers, Mark A. Kornfeld and Joshua B. Rog, *The Supreme Court's Limited Insider Trading Ruling:* Salman *Decision Narrowly Affirms* Dirks *and Leaves Portions of* Newman *Intact*, available at https://www.bakerlaw.com/alerts/the-supreme-courts-limited-insider-trading-ruling-salman-decision-narrowly-affirms-dirks-and-leaves-portions-of-newman-intact, (Dec. 9, 2016).
[3] *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014). For a fulsome discussion of *Newman*, please see Marc D. Powers and Jonathan A. Forman, *Applying* Newman's *Personal Benefit Requirement to Insider Trading Compliance Programs*, CURRENTS (June 2015).
[4] *Dirks v. SEC*, 463 U.S. 646 (1983).
[5] *Id*.
[6] *Id*. at 662.
[7] *Id*. at 664.
[8] *Newman*, 773 F.3d at 542.
[9] *Salman*, 137 S.Ct. at 428.
[10] *Id*. at 427.
[11] *Id*.at 428.
[12] Appellant's post-hearing letter to clerk of the court for the Second Circuit Court of Appeals regarding *Salman*, 14-3599 (2d Cir. Jan. 6, 2017) (ECF No. 152) at 1 (citing *Newman*, 773 F.3d at 452).
[13] Appellee's post-hearing letter to the clerk of the court for the Second Circuit Court of Appeals regarding *Salman*, 14-3599 (2d Cir. Jan. 6, 2017) (ECF No. 151) at 7 (internal citation omitted).
[14] *Martoma*, slip op. at 22 (quoting *Dirks*, 463 U.S. at 664).
[15] *Id*. at 25 (quoting *Salman*, 137 S.Ct. at 328).
[16] *Id*. at 27.
[17] *Martoma*, dissent at 2 (2d Cir. Aug. 23, 2017) (ECF No. 175) (emphasis in original).
[18] *Id*. at 13 (citing *Newman*, 773 F.3d at 452).
[19] *Id*. at 16 (emphasis in original) (quoting *Salman*, 137 S.Ct. at 428).
[20] *Martoma*, slip op. at 28 (emphasis in original).
[21] *Id*. at 30 (internal quotation and citation omitted).
[22] *Martoma*, dissent at 4 (quoting *Dirks*, 463 U.S. at 664).
[23] *Id*. (quoting *Dirks*, 463 U.S. at 664, n.24).
[24] *Id*. at 5 (internal quotation omitted).
[25] *Martoma*, slip op. at 33.
[26] *Martoma*, dissent at 22, n.14.
[27] *Id*. at 17-18 (internal quotation omitted).
[28] *Id*. at 18 (quoting *Salman*, 137 S.Ct. at 427).
[29] *Martoma*, slip op. at 30.
[30] *Id*. at 28, n.8 (citing *Salman*, 137 S.Ct. at 427, 428) (internal quotation omitted).
[31] *United States v. Martoma*, brief for appellee, 14-3599, at 5 (filed May 4, 2015) (ECF No. 85).
[32] *See supra* n.13 at 6.
[33] *Id*.

