ALERTS

Second Circuit, in Split Decision, Overrules Limitation on Insider Trading Liability Established in *U.S. v. Newman*

August 28, 2017

Last week, a divided panel of the U.S. Court of Appeals for the Second Circuit issued another in a series of important insider trading decisions regarding the personal benefit requirement in the context of gifting confidential information, sustaining the conviction of Mathew Martoma, a former portfolio manager. In doing so, the panel expressly overruled a significant aspect of the Court's 2014 decision in *United States v. Newman,* holding that a "meaningfully close personal relationship" was no longer required, at least in the Second Circuit, to prove both civil and criminal insider trading when a tipper makes a gift of material, non-public information. Under the panel's ruling, the personal benefit requirement may be satisfied whenever an insider discloses material, non-public information with the expectation that the recipient will trade on it and the disclosure resembles a gift of trading profits from the insider to the recipient — even if the recipient is not a friend or relative. This holding drew a sharp rebuke from one of the judges on the panel, who both challenged the majority's reasoning and criticized the panel for overruling a decision of an earlier panel without convening an *en banc* session of the full Court.

Notably, even though the *Martoma* decision abrogated a significant gloss on the personal benefit requirement that limited the reach of insider trading laws in the Second Circuit, the decision left standing an equally important limiting aspect of *Newman*, namely that to prove insider trading the government *still* must establish that the tippee knew (or consciously avoided knowledge) that the tipper disclosed the inside information in order to obtain a personal benefit. That aspect of *Newman* remains a critical limitation on insider trading liability, particularly for remote tippees who, unlike immediate tippees, may not know of the tipper's personal benefit.

The Court also emphasized that not every disclosure of inside information will result in insider trading liability; instead, only disclosures of such information that are made with the *intent* that the tippee will trade on the basis of that information (i.e., the functional equivalent of a gift of cash derived from illicit trading) will satisfy the personal benefit requirement. The shift in focus to the tipper's intent, as opposed to the nature of the relationship between tipper and tippee, should still serve to meaningfully limit insider trading liability in the business context in which these issues typically arise. In the usual case, the government will likely be hard-pressed to demonstrate that the tipper's purpose was to make a gift of trading profits to someone who was not a friend or the source of a pecuniary or other tangible benefit.

Thus, although *Martoma* narrowed the personal benefit requirement in the Second Circuit by de-emphasizing the parties' relationship in the analysis, that requirement still remains a crucial limitation in appropriate cases.

Background: *United States v. Newman* and *Salman v. United States*

In *United States v. Newman*, a panel of the Second Circuit Court of Appeals cabined tipper-tippee liability when it held that an inference of a "personal benefit" is "impermissible in the absence of proof of [(i)] a meaningfully close personal relationship that [(ii)] generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[1] Many interpreted the latter portion to mean that, to establish tipper-tippee liability, the government must always show that the tipper received a pecuniary or other tangible benefit. The *Newman* court also held that to establish liability the tippee must know (or consciously avoid knowing) that "the information was confidential and divulged for personal benefit."[2] In *Newman*'s immediate aftermath, four insider trading guilty pleas were vacated[3] and prosecutors were put "on notice that their . . . practice of glossing over [the personal benefit and tippee's knowledge] requirement[s] will likely no longer stand."[4]

Approximately six months after *Newman*, the Ninth Circuit Court of Appeals in *United States v. Salman* declined to follow *Newman*'s limiting principle, at least in the context of family connections or close friendships. Instead the Ninth Circuit held that an inference of a personal benefit *is* permissible when a tipper gifts material, non-public information to a *trading relative or friend*, even in the absence of a pecuniary quid-pro-quo.[5] On Dec. 6, 2016, in a narrowly focused opinion, the Supreme Court affirmed *Salman*'s holding.[6] The Supreme Court's decision in *Salman v. United States* reasoned that a gift of confidential information to a trading relative or friend is akin to an insider unlawfully trading on the basis of confidential information and then doling out the profits to his family and friends as cash gifts.[7]

In *Salman*, the Supreme Court expressly rejected *Newman*'s purported requirement of a "pecuniary or similarly valuable" exchange in the context of gifting confidential information to trading relatives or friends.[8] Importantly, the Supreme Court did not question (or even discuss) the other two important aspects of *Newman*, namely that an inference of a personal benefit is impermissible in the absence of proof of a meaningfully close personal relationship and that the tippee must know that the tipper provided the inside information for the purpose of obtaining a personal benefit.[9] Thus, although the limitations that *Newman* imposed on tipper-tippee liability were partially unwound in *Salman*, questions remained about the scope of liability outside the context of trading relatives or friends. In other words, what inferences may be drawn when an insider gifts confidential information to those with whom he does not share a "meaningfully close personal relationship," such as to complete strangers or mere acquaintances?

Martoma: **The Second Circuit Revisits** ***Newman***

On Aug. 23, 2017, in *United States v. Martoma* — the Second Circuit's "first occasion to consider *Newman* in the aftermath" of *Salman* — a panel of the court abrogated an important part of the *Newman* panel's decision when it held in a 2-to-1 decision that proof of a "meaningfully close personal relationship" is no longer necessary to infer the personal benefit element of tipper-tippee liability.[10] In overruling *Newman* on this point, the majority explained that a close reading of the Supreme Court's *Salman* decision compelled this result, reasoning with which the dissent took issue. In doing so, the majority explained that a personal benefit may be inferred whenever an insider tips information "with the expectation that [the tippee] would trade on it" and the disclosure "resemble[s] trading by the insider followed by a gift of the profits to the recipient."[11] The panel explained that although the parties' relationship may constitute relevant circumstantial evidence about the insider's expectations and purpose, that relationship is not dispositive and that liability could attach even in the absence of a "meaningfully close relationship" between tipper and tippee.[12] Below we summarize the Second Circuit's pivotal ruling, the dissent's strongly-worded concerns, and practical implications for market participants.

The Facts

Mathew Martoma worked as a hedge fund portfolio manager who focused primarily on pharmaceutical and healthcare businesses.[13] He was charged with an insider trading scheme involving two pharmaceutical companies that were jointly developing an experimental drug to treat Alzheimer's disease.[14] Through the use of expert networking firms, Martoma arranged for paid consultations with a doctor who was closely involved with the drug's clinical trials. During the course of 43 consultations, for which the doctor was paid a consulting fee of $1,000 per hour, Martoma came to possess material, non-public information about the drug's efficacy and — by extension — the pharmaceutical companies' financial prospects.[15] The consultations culminated in Martoma being tipped critical information about negative clinical results 10 days before that same information was presented to the public (although no consulting fee was paid for this tip).[16] On the basis of that information, Martoma liquidated his portfolio's stakes in the pharmaceutical companies and shorted their stock; he averted roughly $195 million in losses and reaped $80 million in gains for the hedge fund.[17]

At Martoma's trial, the doctor-tipper testified on the government's behalf. The district judge — acting before *Newman* was decided — instructed the jury that a personal benefit "may, but need not be, financial or tangible in nature" and "could include obtaining some future advantage, developing or maintaining a business contact of a friendship, or enhancing the tipper's reputation."[18] Martoma was convicted and sentenced to nine years' imprisonment.

Martoma's Appeal

Martoma argued on appeal that the district judge's jury instructions were erroneous in light of *Newman*'s limitation against inferring a personal benefit "in the absence of proof of a meaningfully close personal relationship."[19] Specifically, Martoma argued that the jury instructions "permitted conviction if the jury found that the tippers 'gave the information to Mr. Martoma…as a gift with the goal of…developing a personal relationship'"[20] Because a 'developing' personal relationship, by its nature, does not constitute an existing and ongoing personal friendship — let alone a 'meaningfully close' one — Martoma argued that the jury instruction impermissibly allowed the government to convict "based on a gift between persons who are not friends," contrary to *Newman*'s holding.[21]

The Majority Partially Overturns *Newman*

In a 2-to-1 decision authored by Chief Judge Robert A. Katzmann, the Second Circuit rejected Martoma's argument on the basis that *Salman* effectively abrogated *Newman*'s requirement of proof of a meaningfully close personal relationship. The panel explained that even though "the Supreme Court did not have occasion to expressly overrule *Newman*'s requirement that the tipper have a meaningfully close personal relationship with a tippee to justify" the personal benefit inference (that issue was not presented to the Supreme Court in *Salman*), even a Supreme Court decision's "subtle" effect and import may "alter the relevant analysis fundamentally enough to require overruling prior, inconsistent precedent."[22] The panel then held that *Salman* "fundamentally altered the analysis underlying *Newman*'s 'meaningfully close personal relationship requirement'" such that that requirement "is no longer good law."[23]

The panel reasoned that "the straightforward logic of the gift-giving analysis," which was "strongly reaffirmed in *Salman*," is that a corporate insider personally benefits by gifting inside information with the expectation that the recipient would trade on the basis of such information, regardless of the parties' relationship.[24] The personal benefit from "such a disclosure is the functional equivalent of trading on the information…and giving a cash gift to the recipient."[25]

The Second Circuit concluded in *Martoma* that the personal benefit a tipper derives from a gift "is *not* the friendship or loyalty or gratitude of the recipient of the gift; it is the imputed pecuniary benefit of having effectively profited from the trade oneself and given the proceeds as a cash gift."[26] *Newman* was therefore incorrect, according to the majority in *Martoma*, when it "assume[d] that the personal benefit involved in giving a gift was the ephemeral benefit of the friendship of the recipient of the gift."[27] The majority reasoned that there should be no difference in liability between an insider who personally trades and doles the profits out to family and friends and another who gifts the information to a doorman whom he barely knows as long as the purpose of the gift is to enable the doorman to profit from the resulting anticipated trading.[28] Accordingly, a 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 "resemble[s] trading by the insider followed by a gift of the profits to the recipient."[29]

Martoma's holding shifts the analysis from the parties' relationship to the tipper's intent and the tippee's knowledge of that intent. In doing so, the panel acknowledged that this "question of fact [] will not always be easy for courts," and many cases will be decided on the basis of circumstantial evidence.[30] The majority further conceded that "concerns about the sufficiency of [such] evidence…are not wholly without basis," but the proper response to such concerns is not categorically cabining liability on the basis of the parties' relationship; rather, "the response…lies in appellate review of the sufficiency of the evidence of personal benefit."[31] Furthermore, the majority noted that certain disclosures of inside information, such as for "whistleblowing purposes" or "inadvertent disclosures," should not trigger the personal benefit inference.[32]

Importantly, while overruling *Newman*'s "meaningfully close relationship" holding, the panel left undisturbed — and, indeed, did not comment upon — *Newman*'s other critical limitation on insider trading liability, namely that the tippee must know that the tipper disclosed the information in order to obtain a personal benefit. That aspect of *Newman* remains good law even after *Martoma.*

The Dissent Voices Strong Concerns

In a lengthy dissent (that was seven pages longer than the majority's opinion), Circuit Judge Rosemary S. Pooler expressed strong concerns that the majority's opinion "strips the long-standing personal benefit rule of its limiting power…and radically alters insider-trading law for the worse" by expanding "liability in many cases where it could not previously lie" and placing the analysis "largely on the intentions of the parties."[33] According to the dissent, the personal benefit requirement was designed to steer courts away from "attempting to read the parties' minds"; now, however, in light of the newly-introduced "vagueness and subjectivity" to tipper-tippee analysis, market participants will be forced "to rely on the reasonableness of the SEC's litigation strategy."[34]

Moreover, from the point of view of proper appellate review, the dissent noted that "[n]othing in *Salman* [broke] new ground on the [meaningfully close personal relationships] point" articulated in *Newman*; accordingly, the dissent saw no reason to reverse *Newman* and was particularly critical of the majority for doing so "without a hearing en banc."[35] Indeed, because of the tipper's lucrative consulting arrangement, the majority acknowledged that "the evidence...was sufficient to convict under a straightforward pecuniary benefit theory."[36]

Practical Implications

Martoma highlights the hazards of trading on the basis of material, non-public information in anticipation of relying on the absence of a "personal benefit" as a defense. In less than three years, the law in the Second Circuit has journeyed from *Newman*'s double-barreled standard — requiring *both* a "meaningfully close relationship" between the insider and recipient that goes beyond "the mere fact of a friendship" *and* a pecuniary-like exchange[37] — to the *Martoma* test that requires *neither* friendship nor a pecuniary-type benefit and instead focuses on the insider's purpose in sharing information with the recipient. That the *Martoma* inquiry is inherently subjective, in contrast to the more objective (though also amorphous) factors stressed by the traditional personal benefit test, will likely only add to the uncertainty faced by traders and compliance personnel.

The precise impact of *Martoma*'s new legal standard on insider trading enforcement actions remains to be seen. The government can be expected to argue that, whenever a corporate insider discloses inside information to a hedge fund analyst or other person the insider knows to be in the securities industry, the tipper has acted "with the expectation that [the tippee] would trade" on the information. Yet the *Martoma* Court was careful each time it announced its standard to specify that liability attaches only where the tipper 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."[38] Therefore, an insider who discloses information only with awareness that the recipient may trade on it should not, by virtue of that fact alone, be deemed to have received a “personal benefit”— he or she must also have acted with the intent to make a gift of trading profits. Notably, in *Dirks* itself, the insiders disclosed inside information to a person they knew worked as an investment analyst (Dirks), yet nevertheless were found to have acted for a legitimate corporate purpose rather than an illicit one.

Moreover, an important aspect of *Newman* remains good law and is likely to remain an important check on insider trading enforcement actions and prosecutions, particularly against “remote tippees.” Nothing about *Martoma* undermined *Newman*’s holding that a tippee must know that the tipper received a personal benefit in exchange for the tip. Outside the context of an elaborate conspiracy, it is difficult to prove that remote tippees knew (or, in a civil case, should have known) that the information was released in exchange for a personal benefit instead of simply being leaked. Thus, *Newman* may continue to serve as a useful defense to remote tippees who, being several levels removed from the tipper, may not know or have reason to know of the tipper’s personal benefit.

Finally, it remains to be seen whether *Martoma* itself will remain good law. Particularly in light of Judge Pooler’s strong dissent, Martoma can be expected to ask the full Second Circuit to convene an *en banc* hearing to consider the case. For a petition for rehearing *en banc* to be granted, a majority of the Court’s active judges must vote in favor. The Second Circuit currently has 11 active judges (including all three members of the *Martoma* panel). In addition to Judge Pooler, only one of the judges on the *Newman* panel is in active status (the other two are senior judges and thus would not be entitled to vote). The Second Circuit rarely hears cases *en banc*, and the fact that *Martoma* was authored by the Chief Judge may further diminish the likelihood of *en banc* consideration.

Authored by Harry S. Davis, Marc E. Elovitz, David K. Momborquette, Gary Stein, Peter H. White and Mark L. Garibyan.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

---

[1] 773 F.3d 438, 452 (2d Cir. 2014).

[2] *Id.* at 450.

[3] Harry S. Davis et al., Newman'*s Aftermath*, Hedgefund J. (Mar. 5, 2015), *available at* http://www.thehedgefundjournal.com/node/10024.

[4] *SRZ Alert*, "Second Circuit Clarifies Insider Trading Liability of Tippees" (Dec. 15, 2014), http://www.srz.com/resources/second-circuit-clarifies-insider-trading-liability-of-tippees.html.

[5] 792 F.3d 1087 (9th Cir. 2015); *see also Dirks v. S.E.C.*, 463 U.S. 646, 664 (1983).

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

[7] *Id.* at 428.

[8] *Id.* at 425.

[9] Those holdings of *Newman* were not at issue in the Supreme Court's decision in *Salman*.

[10] No. 14-3599, 2017 WL 3611518, at *1 (2d Cir. Aug. 23, 2017).

[11] *Id.* at *8. Although the majority framed the tipper's state of mind as an "expectation" that the tippee would trade on the gift, other portions of the opinion clarify that the dispositive *mens rea* is intent. *See, e.g.*, *id.* at *10 ("As the dissent points out, many cases may rely on circumstantial evidence of *intent*") (emphasis added); *id.* ("In other cases, other witnesses might testify about conversations with a tipper that shed light on the tipper's *intentions*") (emphasis added); *see also id.* at *8 n.8 ("It is for the jury to decide . . . what to infer about the tipper's *purpose* from his relationship with the tippee.") (emphasis added).

[12] *Id.* at *8, n.8.

[13] *Id.* at *1.

[14] *Id.*

[15] *Id.*

[16] *Id.* at *2. Martoma also received material, non-public information from one of the principal investigators on the clinical trial. However, the critical information that led to Martoma's substantial profits (and ultimate arrest) came from the doctor-tipper.

[17] *Id.*

[18] *Id* at *3 (citation omitted).

[19] *Id.* at *6 (citation omitted).

[20] *Id.* at *24 (citation omitted).

[21] *Id.*

[22] *Id.* at *7 (quotation marks and citations omitted).

[23] *Id.* (citation omitted).

[24] *Id.* at *8 (citation omitted).

[25] *Id.*

[26] *Id.* at *9 (emphasis in original) (citation omitted).

[27] *Id.* (quotation marks and citation omitted).

[28] *Id.* at *8.

[29] *Id.* (quotation marks and citations omitted).

[30] *Id.* at *10 (citation omitted).

[31] *Id.* (citation omitted).

[32] *Id.* at *9 (citation omitted).

[33] *Id.* at *11, *18.

[34] *Id.* at *11, *12 (quotation marks and citation omitted).

[35] *Id.* at *22.

[36] *Id.* at *10.

[37] 773 F.3d at 452.

[38] *See* 2017 WL 3611518, at *8; *id.* at *8 n.8; *id.* at,*9; *id.* at *10 (quotation marks and citations omitted) (emphasis added).

---

information does not create an attorney-client relationship with SRZ. Electronic mail or other communications with SRZ cannot be guaranteed to be confidential and will not (without SRZ agreement) create an attorney-client relationship with SRZ. Parties seeking advice should consult with legal counsel familiar with their particular circumstances. The contents of these materials may constitute attorney advertising under the regulations of various jurisdictions.

Related People

Harry Davis

Partner

New York

Marc Elovitz

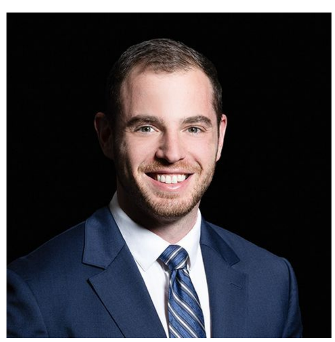
Partner

New York

Peter White

Of Counsel

Washington, DC



Mark Garibyan

Special Counsel

New York

Practices

INVESTMENT MANAGEMENT

LITIGATION

SEC ENFORCEMENT AND WHITE COLLAR DEFENSE

Attachments

Download Alert