

Second Circuit Clarifies “Meaningfully Close Relationship” No Longer Required To Prove Insider Trading Under Gift Theory

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A divided panel of the Second Circuit clarified in *United States v. Martoma*¹ that insider trading does not require proof of a “meaningfully close personal relationship” between a tipper who gifts confidential information and the recipient of the disclosure who either tips or trades on the information. In doing so, the court affirmed the insider trading conviction of Mathew Martoma, a former portfolio manager at S.A.C. Capital Advisors, LLC.² In rejecting Mr. Martoma’s defense that the district court improperly instructed the jury in light of the Second Circuit’s decision in *United States v. Newman*³—which held that a “personal benefit” could not be inferred absent proof of a “meaningfully close relationship” between the tipper and tippee—the Second Circuit held that *Newman*’s requirement was abrogated by the Supreme Court’s decision in *Salman v. United States*.⁴ Mr. Martoma will likely ask the full Second Circuit or the Supreme Court to review the ruling, but in the meantime the decision brings further clarity to insider trading liability and will provide a clearer path for the Government to obtain criminal convictions and findings of civil liability under a “gift theory” of insider trading liability.

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¹ No. 14-3599, 2017 WL 3611518 (2d Cir. Aug. 23, 2017).

² *Id.* at *1.

³ 773 F.3d 438 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015).

⁴ 137 S. Ct. 420 (2016).



Background

To establish insider trading liability against a tippee-trader in a criminal case, the Government must prove that the defendant: (i) traded in securities while (ii) in possession of material, nonpublic information that he knew was (iii) obtained as a result of a breach of duty and (iv) provided by the tipper in exchange for a personal benefit.⁵

The Supreme Court first addressed the question of tippee liability in *Dirks v. SEC*.⁶ There, the Supreme Court held that to show a breach of duty the tipper must “personally [] benefit, directly or indirectly, from [the] disclosure.”⁷ The Supreme Court explained that insiders derive a personal benefit when, for instance, they make a *quid pro quo* exchange for the tip or “gift the confidential information to a trading relative or friend.”⁸ The Second Circuit dealt with the latter situation in *Newman*, decided after Mr. Martoma’s conviction and while his appeal was pending.

In *Newman*, the Second Circuit found that the Government failed to prove at trial that the tippers received a personal benefit in exchange for their disclosures.⁹ The Second Circuit held that the evidence, which indicated little more than a mere casual friendship between the tippers and the first-level tippees in two separate tipping chains, was insufficient to establish a personal benefit.¹⁰ The Second Circuit explained that the personal benefit inferred from a gift of inside information to a trading relative or friend under *Dirks* was not sufficient absent “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.”¹¹

Two years later, in the wake of several high-profile dismissals of criminal and civil cases no longer viable under *Newman*’s restrictive personal benefit standard,

the Supreme Court decided *Salman*, which resolved a split that had developed between the Second and Ninth Circuits and affirmed the Ninth Circuit’s view that a tipper breaches a fiduciary duty by making a gift of confidential information to a “trading relative.”¹² The Supreme Court reasoned that the tipper benefits personally by gifting the information “because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds.”¹³ The Supreme Court rejected *Newman*’s standard that “personal benefit” requires that the tipper receive something of a pecuniary or similarly valuable nature in exchange for the tip.¹⁴ To the extent *Newman* required such an exchange, the Supreme Court explained, it was “inconsistent with *Dirks*.”¹⁵

The Second Circuit’s Decision in *Martoma*

Mr. Martoma was convicted of multiple counts of securities fraud after selling and shorting stock in two companies with rights to a drug being tested to treat Alzheimer’s disease.¹⁶ Mr. Martoma paid two doctors who were working on the drug’s clinical trial for regular consultations relating to the drug. The consultants provided the information despite being under confidentiality obligations. Mr. Martoma placed the trades after learning about problems with the efficacy of the drug from one of the consultants.¹⁷ Mr. Martoma raised two arguments on appeal.

First, Mr. Martoma unsuccessfully challenged the sufficiency of the evidence presented at trial. The Second Court upheld the conviction because, although one of the consultants did not bill Mr. Martoma for two meetings at which he provided Mr. Martoma with certain efficacy data, a rational trier of fact could have found the requisite elements of insider trading under a pecuniary *quid pro quo* theory based on the consultants’ regularly feeding Mr. Martoma confidential information in exchange for fees.¹⁸

⁵ See, e.g., *id.* at 427–29. In a civil enforcement action brought by the SEC, the scienter standard for a tippee is relaxed. The SEC must prove only that the tippee “knew or should have known” about the breach and the personal benefit. *SEC v. Obus*, 693 F.3d 276, 287–88 (2d Cir. 2012) (emphasis added).

⁶ 463 U.S. 646, 649 (1983).

⁷ *Id.* at 662.

⁸ *Id.* at 664.

⁹ 773 F.3d at 452.

¹⁰ *Id.*

¹¹ *Id.*

¹² 137 S. Ct. 420 (2016); 792 F.3d 1087 (9th Cir. 2015) (Rakoff, J.).

¹³ *Salman*, 137 S. Ct. at 428.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ 2017 WL 3611518, at *1–2.

¹⁷ *Id.*

¹⁸ *Id.* at *6.

Second, Mr. Martoma unsuccessfully challenged the district court's jury instruction. Mr. Martoma argued that *Newman*'s requirement of proof of a meaningfully close personal relationship survived the Supreme Court's decision in *Salman*, and that the jury was not properly instructed that it needed to find such a relationship. The Second Circuit rejected Mr. Martoma's argument and clarified that *Salman* abrogated *Newman*'s meaningfully close personal relationship requirement.¹⁹

The Second Circuit explained that *Newman*'s requirement was at odds with the Supreme Court's justification of the gift theory of insider trading liability in *Dirks*—that “[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.”²⁰ The Second Circuit observed that this theory could encompass scenarios outside the context of a meaningfully close relationship, such as an exchange between business school classmates, and thus a categorical rule requiring proof of a meaningfully close relationship would be inconsistent with *Dirks*.²¹

The Second Circuit accordingly held that an insider will be found to have derived a “personal benefit” where he or she disclosed inside information “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.”²² The Court observed that *Salman*'s analysis of the *Dirks* gift theory of liability does not lend itself to confining insider trading liability to those with whom the tipper has a meaningfully close relationship.²³ Rather, the “straightforward logic” of the *Dirks* gift-giving analysis assumes that an insider who discloses inside information with an expectation that the tippee would trade on it will personally benefit from that disclosure, as such disclosure is the “functional equivalent” of the insider's trading himself or herself, and then gifting the profits to the tippee.²⁴

Conclusion

Martoma brings further clarity to insider trading liability. Nevertheless, whether a defendant committed

unlawful insider trading will continue to be a fact-intensive inquiry. Indeed, responding to the dissent's concern that absent *Newman*'s requirement of a meaningfully close personal relationship, any gift to any person would confer a personal benefit on the tipper, the majority clarified that a tipper will be found to have derived a “personal benefit” where he or she disclosed inside information “to someone he *expects will trade on the information*.”²⁵ Thus the personal benefit element remains meaningful. In addition, the relationship between tipper and tippee, as well as the tipper's mental state, may still be relevant to this inquiry, and ultimately “[i]t is for a jury to decide . . . what to infer about the tipper's purpose from his relationship with the tippee.”²⁶

It remains to be seen, in the face of a lengthy and vigorous dissent, whether the full Second Circuit or ultimately the Supreme Court re-examines the majority's determination to effectively overrule another panel's interpretation of the personal benefit element. But in the meantime, the abrogation of *Newman*'s “meaningfully close personal relationship” requirement eliminates one obstacle for the Government in proving criminal and civil insider trading cases. We expect, therefore, that the Government will continue vigorously to pursue insider trading investigations and prosecutions involving alleged gifts of insider information, even potentially in the absence of any obvious pecuniary gain or a close relationship between the tipper and tippee.²⁷

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¹⁹ *Id.* *6–10.

²⁰ *Id.* at *7 (quoting *Dirks*, 463 U.S. at 664).

²¹ *Id.*

²² *Id.* at *8 (quoting *Salman*, 137 S. Ct. at 428; *Dirks*, 463 U.S. at 664).

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.* (emphasis in original).

²⁶ *Id.* at *8 n.8.

²⁷ This Alert Memorandum was prepared with the assistance of Brandon N. Adkins, Emily Scherker, and Pekham Pal.