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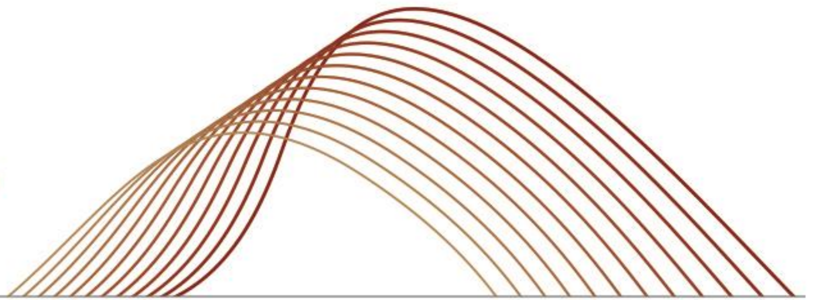

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Second Circuit Decision Expands Insider Trading Liability

By Thomas Zaccaro, Nicolas Morgan & Peter Brejcha

On August 23, a three-judge panel in the Second Circuit issued a split decision on insider trading in the tipper-tippee context that returns uncertainty to an area of the law long plagued by open questions regarding the proper scope of liability. *United States v. Martoma* presented the first opportunity for the Second Circuit to consider tipper-tippee liability in the wake of the Supreme Court's recent decision in *Salman v. United States*, 137 S. Ct. 420 (2016). Prior to *Martoma*, *United States v. Newman*, 779 F.3d 438 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015), was controlling authority in the Second Circuit, holding that the government must show a meaningfully close relationship between the 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." This more restrictive standard was intended to prevent liability from attaching based on more tenuous connections, such as where two individuals were merely "alumni of the same school or attended the same church."

In a single sentence, the *Martoma* majority eviscerated that standard, holding that the "logic of *Salman* abrogated *Newman*'s 'meaningfully close personal relationship' requirement." Instead, Martoma held that a tipper benefits from a disclosure of insider information "whenever the information was disclosed with the expectation [the tippee] would trade on it." The Second Circuit's ruling appears to confirm concerns expressed by many observers after the *Salman* opinion first came down that it would only lead to additional confusion about the precise contours of tipping liability.

The Personal Benefit Test

Tippee liability was first established more than 30 years ago in *Dirks v. SEC*, 463 U.S. 646 (1983). In *Dirks*, the Supreme Court ruled that insiders are forbidden by their fiduciary relationship not only "from personally using undisclosed corporate information to their advantage," but also from giving "such information to an outsider for the same improper purpose of exploiting the information for their personal gain." In these circumstances, "a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information" if the insider "has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."

To establish liability, the government must show that "the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach [by the tippee]."

The focus of the personal benefit test is on objective criteria, "such as a pecuniary gain or a reputational benefit that will translate into future earnings." Nevertheless, the *Dirks* court observed, "the elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient."

The Potential for Pecuniary Gain

Following the Supreme Court's landmark ruling in *Dirks*, the personal benefit test was broadly construed by courts and government prosecutors to encompass essentially any exchange of inside information between friends or family members. This expansive view of the personal benefit test, however, was squarely rejected by the Second Circuit in *United States v. Newman*, 779 F.3d 438 (2d Cir. 2014), *cert. denied*, 136 S. Ct. 242 (2015). In *Newman*, two hedge fund managers were convicted of insider trading under a tipper-tippee theory. The defendants were remote tippees several layers removed from the insiders who originally had disclosed the nonpublic information in violation of their fiduciary duties. The Second Circuit reversed the convictions, finding that the tippees were too remote from the original tippers to have inherited the insiders' fiduciary duties. Interpreting the personal benefit test, the court concluded that such a benefit must be proven by 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."

The Circuits Split

In *United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015), the Ninth Circuit rejected *Newman*'s narrow construction of the personal benefit test. Unlike the remote tippees in *Newman*, Salman was convicted of trading on inside information he received from his brother-in-law, who in turn had received the information from his brother, a member of Citigroup's health care investment banking group. Salman appealed, arguing that under *Newman* the government failed to prove that the original tipper received any pecuniary gain as a result of the disclosures. But the Ninth Circuit affirmed the conviction, finding that gifts of confidential information between family members alone, even in the absence of a pecuniary gain by the tipper, satisfied *Dirks*. In reaching this conclusion, the Ninth Circuit expressly declined to follow *Newman*, and instead relied on the language of *Dirks* that seemingly allowed personal benefit to be shown by "a gift of confidential information to a trading relative or friend."

The Supreme Court Weighs In

In December 2016, in a unanimous opinion authored by Justice Samuel Alito, the Supreme Court affirmed the Ninth Circuit's ruling and expressly adhered to *Dirks*. The Supreme Court reasoned that a tippee engages in insider trading when the tipper has breached a fiduciary duty by disclosing inside information to the tippee, and the tippee "participates in the breach of the tipper's fiduciary duty." Whether the tipper has actually breached its fiduciary duty hinges on the purpose of the tipper's disclosure to the tippee. "'The test . . . is whether the insider personally will benefit, directly or indirectly, from his disclosure.'" A personal benefit in this context can be established through objective facts, such as a "pecuniary gain or reputational benefit that will translate into future earnings," or inferred from evidence of "a relationship between the insider and recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient." Under *Dirks*, the second option may be demonstrated "when an insider makes a gift of confidential information to a trading relative or friend."

Ultimately, Alito concluded that *Dirks* "easily resolve[d] the narrow issue presented here." Evidence at trial demonstrated that the inside information was disclosed between family members, and that the disclosure was made for the purpose of giving a gift. Under the Supreme Court's reasoning, these circumstances are legally indistinguishable from a scenario in which the tipper has traded on the information itself and gifted the proceeds to the tippee.

Left unanswered by Justice Alito's opinion, however, was the critical question of the level of connection that must be shown when the tipper and tippee are not "trading relatives or friends." Rather than addressing this issue head on, the Supreme Court elected to limit its holding to circumstances involving the sharing of information between family members and close friends. Despite this limited holding, Justice Alito did make explicit reference to *Newman*, stating that it was inconsistent with *Dirks* "[t]o the extent [*Newman*] held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends."

The Second Circuit Retreats

Three years after *Newman* was decided, and only months after the Supreme Court's much-anticipated decision in *Salman*, the Second Circuit revisited tipping liability in *Martoma*. Matthew Martoma was a portfolio manager for Steven Cohen's former hedge fund, S.A.C. Capital Advisors, LLC, where he managed a $500 million portfolio focused on pharmaceutical and healthcare companies. Martoma was convicted of securities fraud violations in connection with an insider trading scheme involving shares of Elan Corporation and Wyeth, two pharmaceutical companies that were jointly developing bapineuzumab, an experimental drug to treat Alzheimer's disease.

After S.A.C. acquired shares in both companies, Martoma met with doctors involved in the clinical trials, who shared confidential updates with him about the drug's safety and efficacy in violation of express provisions in their consulting contracts that prohibited them from disclosing any confidential information. Following the disclosures, S.A.C. entered into short-sale and options trades that reduced S.A.C.'s position in the companies. When the final results from the bapineuzumab trial were made public, Elan's share value had plunged 42%, and Wyeth's had fallen 12%. The trades in Elan and Wyeth stock made by S.A.C. prior to the public disclosure generated $80.3 million in gains for S.A.C., and avoided $194.6 million in losses. Martoma personally received a $9.38 million bonus in large part due to the Elan and Wyeth trades.

In *Martoma*, the Second Circuit abandoned the more restrictive approach to tipper-tippee liability it had adopted in *Newman*. Citing the *Dirks* and *Salman* precedents, Chief Judge Robert Katzmann wrote that "an insider or tipper personally benefits from a disclosure of inside information whenever the information was disclosed 'with the expectation [the tippee] would trade on it.'" While acknowledging that the holdings of *Dirks* and *Salman* are largely confined to disclosures made to "trading relative[s] and friend[s]," the split panel nonetheless concluded that "*Salman* fundamentally altered the analysis underlying *Newman*'s 'meaningfully close personal relationship' requirement such that [it] . . . is no longer good law."

Questions Remain

In her lengthy dissent, Judge Rosemary Pooler criticized the *Martoma* majority for "diminishing the limiting power of the personal benefit rule," and hinted that the less rigorous standard adopted by the majority could render all disclosures of inside information actionable. Indeed, the majority ignored key factual distinctions between *Salman* and *Newman*—*Salman* involved the disclosure of inside

information among family members and close friends, while *Newman* involved tippees who were several steps removed from the original tippers.

But despite the well-founded concerns articulated by Judge Pooler, *Martoma* did not hold that the relationship between tipper and tippee is entirely irrelevant to a finding of liability. In a footnote, the majority left the door open for future challenges based on the lack of ties between the tipper and tippee: "[W]e do 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.'"

The Second Circuit may still convene an *en banc* panel to address the questions left unanswered by *Martoma*. Or, the Supreme Court may grant certiorari to review the issues it failed to address in *Salman*. Until then, litigants can only guess how far removed from the tipper a tippee must be to escape liability for insider trading.

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