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Second Circuit Court of Appeals Expands Insider Trading Liability

The Second Circuit Court of Appeals recently affirmed the insider trading conviction of Matthew Martoma, a former portfolio manager for SAC Capital Advisors LLP. In doing so, the court overturned part of *United States v. Newman* and expanded the scope of insider trading liability. If the ruling stands, *Martoma* likely gives prosecutors and regulators more latitude to charge insider trading cases when they cannot prove a *quid pro quo* financial arrangement between a tipper and a tippee.

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On August 23, 2017, the Second Circuit Court of Appeals affirmed the insider trading conviction of Matthew Martoma, a former portfolio manager for SAC Capital Advisors LLP ("SAC Capital"). In doing so, the court overturned part of *United States v. Newman* and expanded the scope of insider trading liability. This is the third time in less than three years that a major court decision has shifted the balance on the scope of insider trading liability. *See United States v. Martoma*, No. 14-3599 (2d Cir. Aug. 23, 2017), applying *Salman v. United States*, 137 S. Ct. 420 (2016) to further limit *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

Courts have repeatedly recognized that not all trading on material, nonpublic information runs afoul of insider trading law. Insider trading liability includes instances when a corporate insider (tipper) breaches a fiduciary duty and discloses confidential corporate information to a recipient (tippee) in exchange for a personal benefit. The personal benefit to the tipper can take the form of a financial or reputational benefit. Prior to *Martoma*, fact-finders in the Second Circuit were permitted to infer that "gifts" of inside information, (i.e., disclosures of information made without a financial gain to the tipper), provided the requisite personal benefit only if there was a "meaningfully close personal relationship" between the tipper and tippee. The court in *Martoma* eviscerated this limitation, holding that the personal benefit test is satisfied whenever (i) inside information is disclosed with the expectation that the tippee would trade on the information, and (ii) the disclosure resembles trading by the tipper followed by a gift of the profits to the tippee, regardless of whether or not there was a meaningfully close personal relationship between tipper and tippee.

It is unclear how lower courts will apply the new personal benefit test. Moreover, the ruling could be reversed by an *en banc* review or by the Supreme Court. However, if the ruling stands, *Martoma* likely gives prosecutors and regulators more latitude to charge insider trading cases when they cannot prove a *quid pro quo* financial arrangement between a tipper and a tippee.

THE PERSONAL BENEFIT TEST PRIOR TO *MARTOMA*

In *Dirks v. SEC*, 463 U.S. 646 (1983), the Supreme Court held that tippees will be liable for insider trading only when "the insider receives a direct or indirect personal benefit from the disclosure" of the material nonpublic information at issue. To determine liability under this test, *Dirks* directed courts to examine "objective criteria," such as whether the tipper's disclosure resulted in a "pecuniary gain or a reputational benefit that will translate into future earnings." A *quid pro quo* arrangement between a tipper and tippee to disclose confidential information in exchange for financial compensation obviously meets this test. The Court observed that liability under this standard could also attach when "an insider makes a gift of confidential information to a trading relative or friend," since the "tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient." Yet, *Dirks* acknowledged that "[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts."

In December 2014, the Second Circuit, in *United States v. Newman*, adopted a narrow reading of the *Dirks* personal benefit test, holding that a tipper's "gift" of inside information to another person will give rise to liability only when there is "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 [for the tipper]." Just nine months ago, the Supreme Court, in *Salman v. United States*, rejected *Newman* to the extent it held that the personal benefit test required "at least a potential gain of a pecuniary or similarly valuable nature[.]" *Salman* explained that an insider who gifts information to "a trading relative or friend[,]" as was the case in *Salman*, receives a sufficient personal benefit to establish a breach of a fiduciary duty, without any additional pecuniary benefit, because "giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds."

In *Salman*, both the Ninth Circuit and the Supreme Court held that *Dirks* itself decided that "the personal benefit test" for liability is met in the particular case "when an insider makes a gift of confidential information to a trading relative or friend." To the extent that the Second Circuit in *Newman* applied some additional requirement in the case of a gift to family or friends, *Salman* declined to follow it. At the same time, *Salman* had no occasion to consider whether the "meaningfully close personal relationship" specified by *Newman* was in fact required to make an insider liable for other gifts of material non-public information.

THE *MARTOMA* CASE

In 2014, Matthew Martoma, a former portfolio manager at SAC Capital, was convicted and sentenced to nine-years in prison for insider trading. Martoma obtained material, non-public information from two doctors who were working on clinical trials for an experimental drug to treat Alzheimer's disease. One of the doctors gave Martoma advance notice of data that indicated the drug was not as effective as previously believed. SAC Capital owned stock in the two pharmaceutical companies that were jointly developing the drug. Martoma caused SAC Capital to short the stocks of the two pharmaceutical companies in advance of the public disclosure of the negative news, resulting in an $80.3 million gain and the avoidance of a $194.6 million loss.

SAC Capital paid the doctor who disclosed the negative information to Martoma for approximately 43 consultations at a rate of $1,000 an hour. SAC Capital did not pay the doctor for the specific conversations and meetings with Martoma that resulted in the disclosure of the negative inside information at issue. Martoma appealed his conviction, arguing, among other things, that he did not have "a meaningfully close personal relationship" with the doctor as required by *Newman* to allow the jury to infer that the doctor obtained a personal benefit from the disclosure that could give rise to insider trading liability.

THE SECOND CIRCUIT'S DECISION

In a 2-1 decision, the Second Circuit affirmed Martoma's conviction, holding that the Supreme Court's reasoning in *Salman* "abrogated *Newman's* 'meaningfully close personal relationship' requirement."[1] The court explained that "when confidential information is given as a gift, it is 'the same thing as trading by the tipper followed by a gift of the proceeds' and is thus the functional equivalent of a cash gift." The court found no reason to distinguish between gifts to individuals with whom the tipper shares a close personal relationship, and gifts to those with whom the tipper does not share such a relationship. To illustrate its point, the court proffered a hypothetical example of a corporate insider, who instead of giving cash to his doorman at the end of the year, gave a tip of inside information with instructions to trade on the information. The court explained that this example was a clear violation of insider trading law despite the absence of a "meaningfully close personal relationship" between the tipper and tippee. The court, citing *Salman*, explained that regardless of whether there is a close personal relationship between the tipper and tippee, a fact-finder can infer that a tipper obtained a personal benefit from a disclosure of confidential information when the disclosure is made "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[.]" The court declined to describe the outer boundaries of when a jury was entitled to rely on circumstantial evidence to infer that a particular disclosure met the new personal benefit test.

Judge Pooler dissented from the court's opinion, writing that "the majority strips the long-standing personal benefit rule of its limiting power." Judge Pooler further wrote that the new test announced by the court is vague and subjective and that "[a]ny disclosure of material, non-public information clearly resembles a gift, in that it provides the recipient with something of value." Judge Pooler expressed her concern that "[j]uries, 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."

TAKEAWAYS AND IMPLICATIONS

While somewhat vague and ill-defined itself, the "meaningfully close personal relationship" requirement of *Newman* provided a more objectively verifiable limitation on when gifts could provide a basis for insider trading liability than the new test announced by *Martoma*. The requirement was met in *Salman* with the close relationship between brothers. It was not met in *Newman*, where a tipper and tippee were acquaintances from school and work but were not "close." Where courts would have ultimately drawn the line between "meaningfully close personal relationships" and other types of relationships was uncertain. Nevertheless, the nature of relationships could have been established by objective evidence of interactions between individuals over the course of the relationship. This is in contrast to the new personal benefit

1. The court also ruled that the evidence at trial was sufficient to prove that the doctor's disclosure of confidential information was part of a pecuniary *quid pro quo* relationship between the doctor and Martoma based on the 43 prior consultations for which the doctor received compensation. The court explained that "having the opportunity to yield future pecuniary gain, constituted a personal benefit giving rise to insider trading liability."

test, which requires prosecutors to establish a tipper's state of mind at a particular moment. This can be done through direct evidence, such as admissions by the tipper, or communications (emails or recorded conversations) that show the tipper's expectation at the time of the disclosure. However, prosecutors may bring a case based solely on circumstantial evidence to show a tipper's state of mind. This circumstantial evidence may be limited to the circumstances surrounding the disclosure of information and the nature of the relationship between tipper and tippee, which need not rise to any specified level. This gives prosecutors more leeway to charge insider trading cases.

Although the *Martoma* case was a criminal case, its holding will apply in the context of civil insider trading cases as well. The SEC, unlike criminal prosecutors, may rely upon a tipper's recklessness to meet its lower burden of proof in any litigation. Thus, while criminal prosecutors must prove that the tipper actually had the expectation that the tippee would trade on the disclosed information, the SEC need only prove that the tipper was reckless in not knowing the tippee would trade on such information. With its lower burden of proof, the SEC may be even more aggressive in pursuing the outer boundaries of insider trading liability.

The goal for business entities and individuals should be to avoid being investigated in the first instance. Once initiated, government investigations can take on a life of their own, moving across subject-matters and jurisdictions, at great cost in terms of money, time and resource diversion, to the subjects of the investigation. Public disclosure of an investigation, even without formal charges, can seriously damage the reputation of an entity or individual.

With this in mind, the changing theories of liability for insider trading should not drive how entities or individuals handle confidential corporate information. The goal should be avoiding questionable activity that could lead to a government investigation. Business entities should implement and enforce policies around the handling of confidential corporate information with this goal. To use the court's hypothetical (and New York-centric) example, corporate insiders should not be tipping doormen with inside information at any time, regardless of the *Martoma* decision. The government has more tools than ever before to detect insider trading, and the chances of engaging in aberrational trading and escaping investigation are lower than they ever have been.

CONCLUSION

It remains to be seen if *Martoma* will survive *en banc* or Supreme Court review. If it does, *Martoma* gives prosecutors and regulators more leeway to charge insider trading cases when they cannot prove a *quid pro quo* financial arrangement between a tipper and tippee. Companies should make certain they have adopted and implemented policies that will prevent and detect conduct that could trigger a government investigation.

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