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Second Circuit Again Holds That Tipper/Tippee Liability Can Arise from a Gift of Inside Information Even Without a Close Personal Relationship

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The Second Circuit confirmed this week that a "meaningfully close personal relationship" is not required for insider-trading liability where a tipper discloses inside information as a gift with the intent to benefit the tippee. The June 25, 2018 decision on panel rehearing in *United States v. Martoma* (No. 14-3599) retreats from the panel's original decision and no longer effectively overrules a portion of the Second Circuit's 2014 decision in *United States v. Newman*, which had refused to infer a tipper's intent to benefit a tippee in the absence of a meaningfully close relationship and a pecuniary or similarly valuable benefit in exchange for the tip. The new panel decision – again a 2-1 ruling – now holds that the requisite relationship described in *Newman* can be established by proving "either [*i*] that the tipper and tippee shared a relationship suggesting a *quid pro quo* or [*ii*] that the tipper gifted confidential information with the intention to benefit the tippee."

The latest decision again means that insider-trading liability can be established in the Second Circuit "by evidence that the tipper's disclosure of inside information was intended to benefit the tippee," regardless of the nature of the tipper's and tippee's personal relationship. Whether the panel's new effort to avoid outright rejection of *Newman* will suffice to prevent *en banc* rehearing and a *certiorari* petition remains to be seen.

Background

The *Martoma* case arose out of the Government's investigation of a prominent hedge fund. Mathew Martoma, a portfolio manager at the fund, had had dealings with two doctors who had been involved in the clinical trial of a drug for Alzheimer's disease. The doctors had entered into paid consulting arrangements with the fund under contracts through expert-networking agencies.

The Government alleged that at least one of the doctors had shared confidential safety data about the drug with Martoma, leading Martoma and the hedge fund to build and maintain positions in the securities of the two companies that owned rights to the drug. The Government also alleged that the doctor had given Martoma advance information of the drug trial's failure – and that the fund had then sold off its positions in the two drug companies' stock before the news became public. Martoma was convicted of insider trading and conspiracy to commit securities fraud.

Martoma appealed, claiming that the Government had not proven that the doctor had received a legally sufficient personal benefit in exchange for providing the confidential information. Martoma's argument focused on the interplay among the Supreme Court's 1983 decision in *Dirks v. SEC*, the Second Circuit's 2014 decision in *Newman*, and the Supreme Court's 2016 decision in *Salman v. United States.*

- The *Dirks* case established the framework for tippee liability. The Supreme Court held that the liability of a tippee (such as Martoma) derives from the liability of his or her tipper (such as the doctor) – and that a tipper breaches a fiduciary duty by disclosing confidential information only if he or she benefits directly or indirectly from the disclosure. The Court gave examples of such a personal benefit, including "a pecuniary gain," "a reputational benefit that will translate into future earnings," "a relationship between the [tipper] and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient," or "a gift of confidential information to a trading relative or friend" where "[t]he tip and trade resemble trading by the [tipper] himself followed by a gift of the profits to the recipient."
- In 2014, the Second Circuit announced a more rigorous construction of *Dirks*'s personal-benefit requirement. The court ruled in *Newman* that*,* to the extent "a personal benefit may be inferred from a personal relationship between the tipper and tippee, . . . such an inference 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*" (emphasis added).
- In 2016, the Supreme Court decided *Salman*, which involved a family relationship: the tipper had allegedly provided confidential business information to his brother, and the brother had then tipped Salman (the trader), whose sister had become engaged to and later married the original tipper. The Court reemphasized *Dirks*'s holding that "a tipper breaches a fiduciary duty by making a gift of confidential information to 'a trading relative'" and added: "when a tipper gives inside

> information to 'a trading relative or friend,' the jury can infer that the tipper meant to provide the equivalent of a cash gift." The Court rejected Salman's reliance on *Newman* for the proposition that the tipper must receive an objective, consequential personal benefit representing an actual or potential pecuniary gain. Rather, the Court held that, "[t]o the extent the Second Circuit held that the 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*."

Martoma argued on appeal that the *Salman* decision did not undermine *Newman*'s requirement that the tipper-tippee relationship be a "meaningfully close personal relationship," because the nature of that relationship had not been at issue in *Salman*, which had involved brothers. Martoma insisted that he and the doctor had not shared a close personal relationship, so *Salman*'s gift-giving analogy was inapposite, and a personal benefit more direct and consequential than mere friendship was required. He also claimed that, even though the doctor had been paid under the consulting arrangement with the hedge fund, the doctor had not been paid for disclosing the drug-efficacy data.

The Second Circuit – in a 2-to-1 decision – affirmed the conviction.

Second Circuit's First Decision

The court first ruled that the evidence was sufficient to sustain Martoma's conviction on a simple pecuniary-benefit theory. The doctor had been paid for his consultations with Martoma. Even if the doctor had not billed Martoma for the specific meetings at which he had conveyed the nonpublic information about the drug trial's failure, "the tipper's gain need not be *immediately* pecuniary." "In the context of their ongoing relationship of *quid pro quo*, . . . where [the doctor] regularly disclosed confidential information in exchange for fees, a rational trier of fact could have found the essential elements of the crime [of insider trading] beyond a reasonable doubt under a pecuniary *quid pro quo* theory."

The majority devoted more of its opinion to discussing the nonpecuniary, gift-giving aspect of insider-trading liability because Martoma had challenged the jury instructions, which had described the personal-benefit theory in terms of both financial and non-financial benefits. The majority concluded that "the logic of *Salman* abrogated *Newman*'s 'meaningfully close personal relationship' requirement" for a non-financial or non-*quid pro quo* personal benefit. The court held that "an insider or tipper personally benefits from a disclosure of inside information whenever [*i*] the information was disclosed 'with the expectation that [the recipient] would trade on it' . . . and [*ii*] the disclosure 'resemble[s] trading by the insider followed by a gift of the profits to the recipient,' . . . whether or not there was a 'meaningfully close personal relationship' between the tipper and the tippee."

In the majority's view, "nothing in [*Salman*'s] logic supports a distinction between gifts to people with whom a tipper shares a 'meaningfully close personal relationship' . . . and gifts to those with whom a tipper does not share such a relationship." *Newman*'s "meaningfully close personal relationship" requirement thus appeared to be a dead letter where a tipper discloses information expecting the tippee to trade on it, and the disclosure is equivalent to the tipper's trading and providing the profits to the tippee as a gift.

The dissent (by Judge Pooler) criticized the majority for rejecting *Newman* without convening the full court for *en banc* review. But Judge Pooler also disagreed with what she viewed as a ruling that "an insider receives a personal benefit when the insider gives inside information as a 'gift' to *any* person. 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."

Martoma petitioned for panel or *en banc* rehearing. The panel issued a new decision – again 2-to-1 – affirming Martoma's conviction, but at least facially modifying the initial decision's rejection of *Newman*.

Second Circuit's Decision on Rehearing

The majority's new decision retreats from abrogating *Newman*'s "meaningfully close personal relationship" element. Instead, the majority reached the same result through what might be called (depending on one's viewpoint) either a more nuanced reconciliation of *Newman* and *Dirks* or a work-around to reduce the risk of *en banc* rehearing and a *certiorari* petition.

Instead of holding that *Salman* undermined *Newman*'s "meaningfully close personal relationship standard," the panel declared that, "because there are many ways to establish a personal benefit, we conclude that we need not decide whether *Newman*'s gloss on the gift theory is inconsistent with *Salman*." The requisite relationship can be established by proving "either [*i*] that the tipper and tippee shared a relationship suggesting a *quid pro quo* or [*ii*] that the tipper gifted confidential information with the intention to benefit the tippee."

The majority focused on what it called "the key sentence of *Dirks*," which it admitted is "ambiguous": the Supreme Court's statement that "there may be a relationship between the [tipper] and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient." The majority concluded that "the comma separating the 'intention to benefit' and 'relationship . . . suggesting a *quid pro quo*' phrases can be read to sever any connection between them," so they stand as alternative elements. Thus, according to the majority, this sentence "effectively reads, 'there may be a relationship between the [tipper] and the recipient that suggests a *quid pro quo* from the latter, or there may be an intention to benefit the particular recipient.'"

Under this disjunctive reading, the government may "prove a personal benefit with objective evidence of the tipper's intent, without requiring in every case some additional evidence of the tipper-tippee relationship." The majority provided an example: "the statement 'you can make a lot of money by trading on this,' following the disclosure of material non-public information, suggests an intention to benefit the tippee in breach of the [tipper's] fiduciary duty." Under the dissent's interpretation, however, "this plain evidence that the tipper intended to benefit the tippee would be insufficient to show a breach of the tipper's fiduciary duty . . . due to the lack of [additional proof of] a personal relationship" between the tipper and the tippee. The majority viewed its reading as more consistent with *Dirks*: "The tipper's intention to benefit the tippee proves a breach of fiduciary duty because it demonstrates that the tipper improperly used inside information for personal ends and thus lacked a legitimate corporate purpose [for disclosing it]. That is precisely what, under *Dirks*, the personal benefit element is designed to test."

Based on this new reading of *Newman*, the majority held that the jury instructions at Martoma's trial had been erroneous. The instructions had "allowed the jury to find a personal benefit based solely on the conclusion that [the doctor] had tipped Martoma in order to 'develop[] or maintain[] a friendship'" but had not told the jury that "it could find a personal benefit based on a 'gift of confidential information to a trading relative or friend' only if it also found that [the doctor] and Martoma shared a relationship suggesting a *quid pro quo* or that [the doctor] intended to benefit Martoma with the inside information."

However, the majority concluded that the inaccurate instructions had not affected Martoma's "substantial rights" because (*i*) "the government produced compelling evidence that [the doctor], the tipper, 'entered into a relationship of *quid pro quo*' with Martoma" in light of the very substantial consulting fees he had received, and (*ii*) "even if a jury were inclined to accept Martoma's argument that there was no *quid pro quo*-like relationship because [the doctor] did not bill Martoma for the two key sessions [at which the doctor had disclosed the drug trial's results], a rational jury could nonetheless find that [the doctor] personally benefited by disclosing inside information with the 'intention to benefit' Martoma."

The majority observed: "We think a jury can often infer that a corporate insider receives a personal benefit (*i.e.*, breaches his fiduciary duty) from deliberately disclosing valuable, confidential information without a corporate purpose and with the expectation that the tippee will trade on it" – in other words, the standard in the now-vacated original panel decision.

Judge Pooler again dissented, opining that "the majority's attempt to undercut the meaningfully close personal relationship requirement is in derogation of circuit precedent and unnecessary to arrive at their disposition. Only by abrogating *Newman* could my colleagues announce a new rule that a jury can infer a personal benefit based on a freestanding 'intention to benefit' and that this 'intention to benefit' is at the core of the meaningfully close personal relationship standard."

Implications

The *Martoma* majority's approach appears to dispense with the personal-relationship element in *Dirks*'s and *Salman*'s discussions of "trading relatives or friends." The tipper's intent to benefit the tippee can now suffice, regardless of the parties' relationship. The decision raises a number of interesting questions and issues.

First, and perhaps most obviously, one wonders whether the panel's new effort to deal with *Newman* will avoid the risk of *en banc* reconsideration. Judge Pooler does not think so; she still believes that the majority has effectively rejected *Newman* without *en banc* review.

Second, although a meaningfully close personal relationship has again been rendered nonessential, another aspect of *Newman* – which the *Martoma* majority called "the central question in *Newman*" – remains intact: the requirement that a tippee must have *known* (or at least have been reckless in not knowing) that the tipper breached his or her duty by providing inside information in exchange for a personal benefit, whatever that benefit might be. Particularly in cases involving remote tippees, this requirement could be decisive – as it was in *Newman*. Remote tippees at the end of a multi-person chain might have little, if any, idea of what happened at the initial tipper's level and might not know whether the tipper breached any duty in exchange for a personal benefit. This prong of *Newman* remains the law in the Second Circuit and is likely to be the first line of defense for remote tippees.

Third, the court's ruling focuses only on tippers who disclose inside information with the expectation that the tippees will trade on it. The majority stressed that its decision does not "mean that a tipper who accidentally or unknowingly reveals inside information can be found guilty. Such a tipper would be protected by the requirement that the tipper know (or is reckless in not knowing) that the information is material and non-public . . . or by the requirement that the tipper expect the tippee to trade." *Martoma* thus would not appear to apply to disclosures for whistleblowing purposes (as in *Dirks*) or to inadvertent disclosures; nor would it appear to apply to disclosures made for legitimate corporate purposes.

Fourth, the decision reaffirms that *Dirks*'s articulation of tipper/tippee liability – including the personal-benefit requirement – applies in misappropriation-theory cases (such as *Martoma*) as well as in classical-theory cases (where a corporate insider breaches a duty by tipping). The decision thus undercuts suggestions by the Government in other cases that a personal benefit is not required under the misappropriation theory.

Finally, the intense scrutiny of the Supreme Court's sentence structure in *Dirks* might cause one to ask whether the Supreme Court actually had focused so closely on the personal-relationship issue in its decisions. *Dirks* had not involved a gift to a trading friend or relative at all. An insider had tipped an investment adviser in the hope of disclosing a corporate fraud; the investment adviser had told his clients; and the insider had not received any benefit except, presumably, the personal satisfaction of having done what he thought was a public service. *Salman* involved a gift to a brother, so the Court did not need to consider whether friendship – or what degree of friendship – could satisfy the personal-benefit requirement in the absence of a pecuniary or other "consequential" benefit.

The absence of a personal relationship in *Dirks*, however, was perhaps an anomaly. In the real world, the existence of a personal relationship might not disappear from insider-trading law. The scenario in which a tipper provides material nonpublic information to a tippee and then says "you can make a lot of money by trading on this" seems unlikely to occur unless some sort of relationship exists between them.