SEYFARTH SHAW

Management Alert

A New and Important Development in Insider Trading Law

By Karen Y. Bitar

In a case likely to have ongoing ramifications, the Second Circuit recently upheld the conviction of Matthew Martoma,[1] a former portfolio manager for Stephen Cohen's SAC Capital. In so doing, the court clarified, at least for now, the Second Circuit's view on an important open issue as to the law of insider trading. A divided court reversed its own 2015 opinion in *United States v. Newman*.[2] Newman held that a "meaningfully close personal relationship" between a tipper and a tippee, and an exchange of something "pecuniary or similarly valuable in nature" to the tipper was required to prove an insider trading violation.[3] *Newman* had a substantial impact on insider trading prosecutions in the Second Circuit because it extended the personal benefit test laid out in the seminal case of *Dirks v. SEC*.[4] In *Martoma*, the Second Circuit reversed course on the need for a close personal relationship requirement, noting that the recent Supreme Court decision in *Salman v. U.S.*[5] "abrogated" the requirement and "was no longer good law".[6] This Management Alert will provide the relevant history surrounding the issue, and offer some possible scenarios as to what may follow.

Background

A. *Dirks*

Until *Dirks* the law relating to liability for insider trading by tippees was unclear. In *Dirks*, the Supreme Court addressed the applicability of insider trading law with respect to those who traded on confidential nonpublic information received from an insider. *Dirks* concluded that the appropriate test for determining whether or not there was a breach of the antifraud provisions of federal securities laws turned on whether an *insider* benefited by tipping the material nonpublic information to another non-insider. Thus, the test after *Dirks* was whether an insider breached a duty by tipping the information for his or her personal benefit, noting that "absent some personal gain [to the insider] there has been no breach of duty to stockholders. And absent a breach by the insider there is no derivative breach [by the tippee].[7]

B. *Newman*

Interpreting *Dirks*, *Newman's* requirement 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 in nature" set a high standard for the government to meet.[8] *Newman* also required the tippee to know not only of the insider's breach, but that

1 *U.S. v. Martoma*, No. 12 Cr. 973, 2014 WL 4384143 (S.D.N.Y. Sept. 4, 2014), *aff'd*, No. 14-3599, 2017 WL 3611518 (2d Cir. Aug. 23, 2017).
2 *U.S. v. Newman*, 773 F.3d 438 (2d Cir. 2014), *reh'g denied*, Nos. 13-1387, 13-1917, 2015 WL 1954058 (2d Cir. Apr. 3, 2015), *cert. denied*, 136 S.Ct. 242, 193 L.Ed.2d 133 (2015)
3 *Id*, at 452.
4 *Dirks v. SEC*, 463 U.S. 646 (1983).
5 *Salman v. U.S.*, 137 S.Ct. 420, 196 L.Ed.2d 351 (2016).
6 *Martoma*, 2017 WL 3611518, at *7, 19.
7 *Dirks*, 463 U.S. at 662.
8 *Newman*, 773 F.3d at 452.

the insider acted in order to receive a personal benefit.[9] As such, it significantly curtailed cases involving remote tippees, like the defendants in *Newman*, who knew neither the tipper nor the original tippee.

With *certiorari* denied, *Newman* never made it to the United States Supreme Court -- but soon thereafter the Ninth Circuit case *Salman v. U.S.* did.[10]

C. *Salman*

In *Salman*, the Supreme Court reaffirmed the personal benefit requirement set forth in *Dirks*, but clarified the standard by concluding that the tipper's personal benefit need not be pecuniary; the benefit may be inferred when an insider gifts information to a relative. Critically, the Court stated that, to the extent the Second Circuit, in *Newman* held that an insider must receive something "pecuniary or similarly valuable in nature" in exchange for the information, that requirement is inconsistent with the Supreme Court's holding in *Dirks*.[11] Thus, *Salman* put to rest that a tipper must receive a pecuniary or other tangible benefit, holding that gifting information to a trading relative or friend was a sufficient personal benefit in and of itself. Purposefully left open in *Salman*, however, remained the issue of how close a relationship must there be between a tipper and tippee outside the context of relatives or friends sufficient to satisfy the personal benefit requirement set forth in *Dirks*.[12]

However, although the Court declined to address more broadly the nature of what constituted a personal benefit, it rejected the Government's argument that disclosure of confidential information to anyone, as opposed to a relative, friend or one otherwise acquainted with the tipper, would constitute a personal benefit sufficient to satisfy *Dirks*.

D. *Martoma*

Turning now to *Martoma*. *Martoma* was convicted in February 2014 and sentenced to nine years in prison because he received and traded on inside information relating to poor results in a clinical trial for an Alzheimer drug, enabling SAC to generate profits and avoid losses totaling $275 million after the results became public. A doctor who had confidential information relating to the clinical trials provided the information to *Martoma*. *Martoma* argued on appeal that the evidence against him was insufficient under *Newman*, which opinion was issued while his appeal was pending. *Martoma* argued that under *Newman*, his conviction should be thrown out because the relevant physician was only a casual acquaintance, and, although routinely paid as a consultant to SAC, he was not paid for the two consulting meetings during which he delivered the tips and thus there was insufficient evidence the doctor received a personal benefit.

The Second Circuit held that *Newman's* holding was overturned by *Salman*, which held that proving a pecuniary benefit is unnecessary if a tipper gifts information to a relative or friend because in such circumstances a benefit can be inferred. The Second Circuit also noted that, in any event, the doctor in question had received numerous consulting fees as a result of his relationship with *Martoma*, so he did receive a pecuniary gain from which a rational trier of fact could have found a quid pro quo in their consulting relationship.

Importantly, as *Salman* involved trading between close family members, it did not address, let alone explicitly overrule, *Newman's* meaningful close personal relationship requirement. Indeed it did not foreclose the argument that giving a gift to a trading tippee with whom the tipper has only a casual relationship might still meet *Dirks* personal benefit requirement. The majority in *Martoma* addressed the issue head on, noting that "it would ordinarily be neither appropriate nor possible for [a panel] to reverse an existing Circuit precedent, *Shipping Corp. of India v. Jaldhi Overseas Pte. Ltd.*[13] but also noted that "a three-judge panel may [do so]... where an intervening Supreme Court decision casts doubt on the prior ruling". *Doscher v. Sea Port Grp. Sec. LLC*.[14] Thus, it concluded that it was proper for it to act because "*Salman* fundamentally altered the analysis underlying *Newman's* meaningfully close personal relationship requirement rendering it "no longer good law".[15]

9 *Id.* at 446.
10 *U.S. v. Salman*, 618 F. App'x 886 (9th Cir. 2015).
11 *Newman*, 773 F.3d at 452.
12 Indeed, in writing for a unanimous Court, Justice Alito made clear that, based on the specific facts before the Court, which involved "precisely the gift of confidential information to a trading relative that Dirks envisioned", adherence to Dirks "easily resolves the narrow issue presented here", but that" [d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts." *Salman v. U.S.*, 137 S.Ct at 425, 427, 429.
13 *Shipping Corp. of India Ltd. v. Jaldhi Overseas Pte. Ltd.*, 585 F3d. 58, 67 (2d Cir. 2009), *cert. denied*, 559 U.S. 1030 (2010).
14 *Doscher v. Sea Port Grp. Sec. LLC*, 832 F.3d 372, 378(2d Cir. 2016).
15 *Martoma*, 2017 WL 3611518, at *7.

The Dissent

In a strongly worded dissent, more lengthy than the majority opinion, Judge Rosemary Pooler argued that the majority had gone too far in limiting the personal benefit requirement set forth in *Dirks*, "[t]he majority holds that an insider receives a personal benefit when the insider gives 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. What counts as a "gift" is vague and subjective. Juries, 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."[16] Further, and more importantly, Judge Pooler argued that while *Salman* overturned *Newman's* holding that a tipper receive something "of a pecuniary or similarly valuable nature" it also referenced *Newman's* holding that the inference of a personal benefit from a gift "is impermissible in the absence of proof of a meaningfully close personal relationship."[17] Indeed Judge Pooler noted that the Supreme Court "explicitly stated that it overruled Newman *'only to the extent'* that it required an insider to "receive something of a pecuniary or similarly valuable nature as a result of giving a gift to a friend".[18] She concluded that "the Supreme Court's statement showed no disapproval of the 'meaningfully close personal relationship' language in *Newman*,"[19] and "had the Supreme Court discussed the "meaningfully close personal relationship" requirement of Newman -- which it did not -- that discussion would have been dicta."[20] Finally, Judge Pooler complained that the majority overruled the holding of Newman without convening the Court *en banc* and dissented on that independent basis. Her criticism invites the obvious question -- what is next?

What Is Next?

In light of the significance of the opinion and the length and strenuous objection set forth in the dissent, it would be surprising if *Martoma* did not ask for *en banc* review. A vote of the majority of the Second Circuit's eleven active judges is needed for that review to occur. Here, *Salman* did not overrule *Newman's* personal relationship requirement yet the majority expressly did so. Other Second Circuit Judges may view this as an abuse of that panel's authority on an important issue, and one which should not have been decided by less than the full Second Circuit. In addition to Judge Pooler, those judges who were part of the majority in *Newman*, for example, may have strong views on this issue, concurring in the need for an *en banc* review. In addition, should the Second Circuit decline to hear the case.[21] *Martoma* can also seek *certiorari* before the Supreme Court which, if it so chooses, can resolve the "close personal relationship" issue once and for all. One thing, however, is abundantly clear. The majority and dissenting opinions set forth in *Martoma* have carefully articulated their respective positions, and there is little doubt that those arguments will be advanced by prosecutors and defense counsel as insider-trading cases come before the Courts. Indeed, picking up on the Second Circuit sea-change between *Newman* and *Martoma* could mean that other Circuit Courts address the "close personal relationship" requirement as well. Should a split occur between the Circuits this would make Supreme Court review more likely, and perhaps inevitable.

If you have any questions, please contact Karen Bitar at *kbitar@seyfarth.com.*

16 *Id.* at *11
17 *Salman v. U.S.* 137 S.Ct. at 422, 425 (internal citations omitted).
18 *Martoma*, 2017 WL 3611518, at *16. (emphasis added).
19 *Id.* at *17.
20 *Id.* at *17.
21 "The Government sought *en banc* review in Newman, an extremely controversial decision when rendered, which request was denied by the Second Circuit. This prompts some court watchers to believe that an *en banc* review will not be granted since it is used so sparingly in the Second Circuit. Other observers, however, note that the propriety of a two judge majority panel overruling Second Circuit precedent will necessitate such a review.