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Martoma — The Latest Critical Insider Trading Decision

By **David I. Miller and Grant MacQueen** (June 27, 2018, 1:03 PM EDT)

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On June 25, 2018, the U.S. Court of Appeals for the Second Circuit revisited its August 2017 insider trading decision in United States v. Martoma,[1] amending its earlier landmark opinion to avoid a panel conflict with the Second Circuit's 2014 decision in United States v. Newman.[2] In its amended opinion, the court again tackles an unanswered question left in Newman's wake: What are the contours of a tipper's required "personal benefit" in a gift-giving context? In Martoma II, the court walks back its personal-benefit definition and rejection of Newman, but, as shown below, may achieve the same practical result as Martoma I. Martoma II is the latest in a string of critical insider trading decisions and may have significant ramifications for the government's enforcement efforts.

Grant MacQueen

A Brief Recap: The Personal Benefit Issue

In Dirks v. U.S. Securities and Exchange Commission,[3] the U.S. Supreme Court established tipping liability, holding that a tippee can be derivatively liable for insider trading when a tipper breaches a fiduciary duty by disclosing the inside information. The court found that whether an insider breached a fiduciary duty hinges on "whether the [tipper] personally will benefit, directly or indirectly, from his disclosure,"[4] and that such a benefit includes "an insider mak[ing] a gift of confidential information to a trading relative or friend."[5] Thus, if the insider/tipper received no personal benefit for tipping, then there was no violation of law and a tippee could not be derivatively liable.

The seeds of Martoma were planted in the circuit's decision in Newman, which established a heightened standard for the government to satisfy in the area of tipping liability. Newman redefined the personal-benefit standard to require a "meaningfully close personal relationship" in the gift-giving context that presented "at least a potential gain of a pecuniary or similarly valuable nature."[6] Then, in December 2016, the Supreme Court issued its first insider trading decision in almost 20 years in United States v. Salman.[7] As described below, the Supreme Court — following Dirks — found that an insider who gifts inside information to a trading relative or friend receives the requisite personal benefit.

After Salman, an open issue remained as to whether any gift sufficed to establish a personal benefit, regardless of personal relationship, or whether a close personal relationship was necessary to satisfy the personal-benefit requirement, setting the stage for Martoma.

The Newman Decision

In Newman, the defendants were "remote" or "downstream" tippees convicted of trading on material nonpublic information received from other tippees. The Second Circuit reversed both convictions, holding that a tippee only knows of the tipper's breach of fiduciary duty if "he knew the information was confidential and divulged for personal benefit."[8] The court further held that a personal benefit cannot be inferred "by the mere fact of a friendship" but rather must be established through "proof of a meaningfully close relationship that generates an exchange that is objective, consequential, and that represents at least a potential gain of a pecuniary or similarly valuable nature."[9] This dual holding made it more difficult for the government to prosecute tippees in the gift-giving context, particularly remote tippees.

The Salman Decision

But then the government was handed a victory: United States v. Salman. In Salman, defendant Bassam Yacoub Salman, a remote tippee, received and traded on material nonpublic information from his brother-in-law, who had obtained the information from his older brother, an investment banker at a large bank. The evidence showed that Salman was aware that the material nonpublic information originated with the investment banker, but there was no evidence that the banker received any pecuniary benefit for tipping his brother. Salman was convicted at trial, his conviction was upheld by the U.S. Court of Appeals for the Ninth Circuit, and the Supreme Court granted certiorari.

The Supreme Court rejected Salman's argument that an insider must always receive a pecuniary quid pro quo from a tippee to establish a personal benefit. The court noted that Dirks made clear that a tipper breaches a fiduciary duty, and thus receives a personal benefit, by gifting confidential information to a "trading relative or friend," as clearly happened in that case.[10]

As to Newman, the court found that "[t]o the extent the Second Circuit [in 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, Newman, 773 F.3d at 452, we agree with the Ninth Circuit that this requirement is inconsistent with Dirks."[11] The court held that Salman's jury was properly instructed and, accordingly, the court affirmed the Ninth Circuit's judgment.

The Martoma Case

Mathew Martoma worked as a portfolio manager at SAC Capital Advisors LP, focusing on pharmaceutical and health care companies. Martoma caused SAC to acquire shares of two companies that were jointly developing bapineuzumab, an experimental Alzheimer's drug. Insider Dr. Sidney Gilman, chair of the safety monitoring committee for the bapineuzumab clinical trial, provided information about bapineuzumab to Martoma in meetings arranged by an expert networking firm. Gilman participated in approximately 43 consultations with Martoma, for some of which he was paid $1,000 per hour. Gilman allegedly disclosed test results and other confidential information to Martoma during the consultations despite his obligation to keep the results of the clinical trial confidential. On July 17 and 19, 2008, in advance of a July 29, 2008, conference at which Gilman was due to present bapineuzumab test results, Gilman and Martoma met. Shortly thereafter, on July 21, 2008, SAC engaged in short selling and options trading concerning the two companies at issue. On July 29, 2008, immediately following Gilman's presentation, the share prices of the two companies fell significantly. SAC's trades in advance of the presentation resulted in approximately $80 million in gains and $195 million in averted losses.

Martoma was indicted for insider trading in the Southern District of New York, and on Sept. 9, 2014, Martoma was convicted following a four-week trial at which Gilman testified. While Martoma's appeal was pending, the Second Circuit decided Newman and, after the Second Circuit heard oral argument in the Martoma appeal, the Supreme Court decided Salman. The Second Circuit requested additional briefing.

On appeal, Martoma argued that (1) the evidence presented at trial was insufficient to support his conviction and (2) the jury was not properly instructed in light of the Second Circuit's decision in Newman. As to sufficiency, Martoma argued that he and Gilman did not have a "meaningfully close personal relationship" and that Gilman had not received any pecuniary or similarly valuable gain in exchange for providing Martoma with confidential information.[12] As to the second ground for appeal, Martoma argued that Newman's gloss on the meaning of a personal benefit — i.e., requiring a "meaningfully close personal relationship" when a gift is made by an insider to a tippee — survived Salman, and the Martoma jury was not properly instructed on it.[13]

Martoma I: The Original Opinion

In addressing Martoma's sufficiency challenge, the majority found that even though Gilman did not bill Martoma for the two July 2008 meetings at which Gilman provided Martoma with critical testing information, Gilman and Martoma maintained a quid pro quo relationship that presented the opportunity to "yield future pecuniary gain."[14] The court noted that "Martoma was a frequent and lucrative client for Dr. Gilman," and "[a]t the same time, Dr. Gilman was regularly feeding Martoma confidential information about the safety results of clinical trials involving bapineuzumab."[15] The court held that in the context of Gilman's ongoing relationship, where Gilman regularly disclosed confidential information in exchange for fees, a rational trier of fact could have found the essential elements of insider trading — in particular, a sufficient personal benefit for Gilman — under a pecuniary quid pro quo theory.[16]

As for Martoma's jury-instruction challenge, the majority held that even though Salman did not explicitly reject Newman's "meaningfully close personal relationship" requirement, the logic of Salman abrogated it. The court found that "the straightforward logic of the gift-giving analysis in Dirks, strongly reaffirmed in Salman, is that a corporate insider personally benefits whenever he discloses inside information as a gift with the expectation that the recipient would trade on the basis of such information or otherwise exploit it for his pecuniary gain."[17] The court reasoned that this is so because "such a disclosure is the functional equivalent of trading on the information himself and giving a cash gift to the recipient."[18] In a broad pronouncement, the court held that: "an insider or tipper personally benefits from a disclosure of inside information whenever the information was disclosed 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, whether or not there was a meaningfully close personal relationship between the tipper and tippee."[19]

After concluding that Newman's "meaningfully close personal relationship" requirement was superseded, the court considered whether the district court's jury instructions were erroneous. The court found that the jury instructions did not constitute obvious error, and further held that, even if the jury instructions were obviously erroneous, the error did not impair Martoma's substantial rights in light of the "compelling evidence that Dr. Gilman, the tipper, received substantial financial benefit in exchange for providing confidential information to Martoma."[20]

Judge Rosemary S. Pooler issued a lengthy dissent and characterized the majority opinion as holding

that "an insider receives a personal benefit when the insider gives inside information as a 'gift' to any person."[21] Judge Pooler concluded that Newman included two holdings: (1) "when the government wishes to show a personal benefit based on a gift within a friendship, as permitted by Dirks, the friendship must be 'a meaningfully close personal relationship,'"[22] and (2) "an insider's gift to a friend only amounted to a personal benefit if the gift might yield money (or something similar) for the insider."[23] Judge Pooler opined that Salman overturned only the second of those holdings.

One area of agreement for the majority and the dissent was that Salman expressly rejected Newman's requirement that the relationship between tipper and tippee "generate an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[24]

Martoma II: The Amended Opinion

In the aftermath of Martoma I, practitioners criticized the panel opinion for its finding that Salman had essentially abrogated Newman, without an en banc ruling. The amended opinion, Martoma II, like Martoma I, focuses on the "'personal benefit' element of insider trading law,"[25] but with an important twist — it no longer challenges Newman. Martoma II does reach the same ultimate conclusion as the original opinion but within the contours of the personal-benefit standard established by Newman.

As in Martoma I, the Second Circuit again considered Martoma's arguments that: (1) the jury instructions improperly failed to "qualify that evidence of a gift to a trading relative or friend establishes a personal benefit only where there is a 'meaningfully close personal relationship,'" and (2) "the evidence at trial was insufficient to sustain a conviction under any theory of personal benefit."[26]

First, in addressing Martoma's jury-instruction challenge, the majority walked back its finding of Salman's abrogation of Newman's requirement of a "meaningfully close personal relationship." Instead, the court concluded that "because there are many ways to establish a personal benefit, we … need not decide whether Newman's gloss on the gift theory is inconsistent with Salman."[27] But the court went on to cabin Newman in finding that "meaningfully close personal relationship" can be found where a tipper gifts inside information (1) to someone with whom the tipper shares a quid pro quo relationship or (2) with the intention to benefit the recipient of the information.

The court focused particularly on the "intention to benefit" language as sufficient to satisfy Newman's "meaningfully close personal relationship" requirement in the gift-giving context. The court noted that its focus is consistent with Dirks because the existence of a breach in the tipper's actions "'depends in large part on the purpose of the disclosure' … [and thus] it makes perfect sense to permit the government to 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."[28] Indeed, according to the court, the personal benefit "may be indirect and intangible and need not be pecuniary at all."[29]

The court did conclude that the jury instructions were erroneous but not because they omitted the term "meaningfully close personal relationship," as Martoma argued. Rather, the court held that the jury instructions erroneously allowed the jury to find a personal benefit in the form of a "gift of confidential information to a trading relative or friend" without requiring the jury to find either that the tipper and tippee shared a relationship suggesting a quid pro quo or that the tipper gifted confidential information with the intention to benefit the tippee. But the court held that this error did not impair Martoma's substantial rights in light of the "compelling evidence that at least one tipper received a different type of

personal benefit from disclosing inside information: $70,000 in 'consulting fees.'"[30]

Interestingly, near the end of the majority opinion, the court suggested that, despite the issuance of Martoma II, the broader interpretation of a personal benefit set out in Martoma I may remain viable: "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."[31]

Second, in briefly addressing Martoma's sufficiency challenge, the majority left largely undisturbed its holding in Martoma I, finding that even though Gilman did not bill Martoma for the two July 2008 meetings at which Gilman provided Martoma with the critical bapineuzumab testing information, Gilman and Martoma maintained a quid pro quo relationship.[32] As for that relationship, the court noted that "Dr. Gilman, over the course of approximately 18 months and 43 paid consultation sessions for which he billed $1,000 an hour, regularly and intentionally provided Martoma with confidential information from the bapineuzumab clinical trial."[33] The court held that in the context of Gilman's ongoing quid pro quo relationship, where Gilman regularly disclosed confidential information in exchange for fees, this evidence was sufficient to support Martoma's conviction.[34] Further, the court noted that even if a jury accepted Martoma's argument that there was no quid pro quo benefit during the two key sessions, a rational jury could find that Gilman personally benefited then by disclosing the information with the "intention to benefit" Martoma.[35]

In Martoma II, Judge Pooler issued another dissent criticizing the majority opinion, characterizing the majority opinion as amounting to an improper abrogation of Newman's requirement of a "meaningfully close personal relationship" in a gift-giving context.[36] Specifically, Judge Pooler opined that a "meaningfully close personal relationship" cannot be proven without objective evidence concerning the nature of the tipper-tippee relationship and, therefore, a tipper's intention to benefit a tippee, standing alone, should not be sufficient to establish a personal benefit.[37]

Martoma's Implications

Martoma II is significant for multiple reasons. As the Second Circuit noted in Martoma I, "[t]his appeal is our first occasion to consider Newman in the aftermath of the Supreme Court's recent decision in [Salman]."[38] While in Martoma I, the Second Circuit found that Newman's personal-benefit requirement fails in light of Salman, in Martoma II, the Second Circuit reversed course, holding that the court need not decide whether Newman's gloss on personal benefit is inconsistent with Salman.[39] The court further held that even under Newman, the personal-benefit test is met when a tipper gifts inside information with the "intention to benefit" the tippee. Through its amended opinion, and restraint in challenging Newman, the court may have provided a basis for a denial of rehearing en banc. Of course, the Martoma saga may not be over should certiorari be granted.

For now, the Second Circuit's "intention to benefit" inquiry in the gift-giving context provides the government some ammunition in asserting that the pecuniary gloss of Newman is limited, potentially aiding the government's prosecution of tipping cases. But if the last four years of insider trading law has shown anything, it is that without a clearly defined statute proscribing insider trading, litigation in this critical area of enforcement is clearly not over.

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[1] 869 F.3d 58 (2d Cir. 2017) ("Martoma I").

[2] 773 F.3d 438 (2d Cir. 2014).

[3] 463 U.S. 646 (1983).

[4] Id. at 662.

[5] Id. at 664.

[6] 773 F.3d at 452.

[7] 137 S. Ct. 420 (2016).

[8] 773 F.3d at 450 (emphasis added).

[9] Id. at 452.

[10] 137 S. Ct. at 427.

[11] Id. at 428.

[12] Martoma II, slip op. at 5.

[13] Id.

[14] Martoma I, 869 F.3d at 66-67 (quoting Newman, 773 F.3d at 452).

[15] Id. at 67.

[16] Id.

[17] Id. at 69.

[18] Id.

[19] Id. at 70.

[20] Id. at 73.

[21] Id. at 75.

[22] Id. at 78-79.

[23] Id. at 79.

[24] Id. at 77 n.6, 80, 83.

[25] Martoma II, slip op. at 4.

[26] Id. at 5.

[27] Id. at 14.

[28] Id. at 23-24.

[29] Id. at 24-25.

[30] Id. at 6.

[31] Id. at 36.

[32] Id. at 35.

[33] Id. at 33.

[34] Id. at 33-35.

[35] Id. at 35-36.

[36] United States v. Martoma, No. 14-3599, Dkt. No. 227 (2d Cir. June 25, 2018) (Pooler, J., dissenting) (hereinafter, Martoma II Dissent), at 2.

[37] Martoma II Dissent, at 2-3.

[38] Martoma I, 869 F.3d at 60.

[39] Martoma II, slip op. at 14.