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Divided Second Circuit Panel Overrules Prior *Newman* Insider Trading Decision

On Wednesday, in *United States* v. *Martoma*, the United States Court of Appeals for the Second Circuit overruled its own 2014 decision in *United States* v. *Newman* and altered the standard for determining whether the personal benefit element of insider trading has been satisfied. The decision had been eagerly anticipated as a key test for how courts would interpret the U.S. Supreme Court's 2016 decision in *Salman* v. *United States*.

For more than 30 years, since the Supreme Court's seminal decision in *Dirks* v. *SEC*, the dividing line between lawful trading on material, nonpublic information and unlawful insider trading has been whether the tipper breached a duty in exchange for a "personal benefit." In most cases, courts have had little difficulty defining the boundaries of that requirement because either the tipper received a financial benefit, or the tippee was a close friend or relative with whom the insider had no legitimate, business reason to be sharing confidential corporate information. In those circumstances, courts have generally permitted an inference of a personal benefit.

In *Newman*, however, the Second Circuit was faced with a corporate insider (an investor relations employee) who shared information with an analyst at an institutional investor. In order to enforce the dividing line created by the *Dirks* Court, and avoid chilling legitimate communications between market professionals and company insiders, the Second Circuit in *Newman* held that, in the absence of an explicit *quid pro quo*, a gift of confidential information from a tipper to a tippee could only amount to a "personal benefit" when the tipper had a "meaningfully close personal relationship" with the tippee.

On Wednesday, however, the Second Circuit panel majority in *Martoma* overruled that test and created a new standard for defining the boundaries of the "personal benefit" requirement: a "personal benefit" to the tipper may exist "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."[1] One judge dissented from the panel's decision.

If the Second Circuit's new test for determining "personal benefit" survives a potential *en banc* review, it will remain to be seen how lower courts implement that test, particularly in the context of communications between a corporate insider and a market professional. It will be incumbent upon the courts to ensure the test has real teeth to address the Supreme Court's concerns in *Dirks* and avoid blurring the line between lawful and unlawful trading.

The "Personal Benefit" Requirement

In *Dirks* v. *SEC*,[2] the U.S. Supreme Court held that trading on material, nonpublic information is not, without more, unlawful. Rather, tippers must receive a personal benefit for insider trading to be unlawful.[3] The Court viewed it as "essential" that there be a "guiding principle" for market participants "whose daily activities must be limited and instructed by the SEC's inside-trading rules."[4] Accordingly, the Court held that the "test" for determining whether such a breach has occurred is "whether the insider personally will benefit, directly or indirectly, from his disclosure."[5] "Absent some personal gain" by the insider, there has been no breach and thus no duty to refrain from trading.[6]

Prior to the Second Circuit's 2014 decision in *United States* v. *Newman*, the personal benefit requirement was generally not perceived as imposing a particularly high bar. Nonpecuniary benefits, including friendship and "gifts" of information, were generally viewed as sufficient to constitute a personal benefit that triggered a duty to abstain from trading. But in many of those cases, the facts easily permitted an inference of a personal benefit because the tippee was a close friend or relative and therefore the insider had no legitimate reason to be discussing corporate information with them.

In *Newman*, however, where the tippee was a market professional whose job involved speaking to company insiders, the Second Circuit imposed a more stringent test of what constitutes a personal benefit.[7] In that case, portfolio managers at two hedge funds were convicted after trial based on alleged tips from an investor relations employee to an analyst. The government argued that the personal benefit to the investor relations employee included career advice and friendship.[8] The *Newman* panel held that in the context of a gift of inside information, a personal benefit to the tipper requires "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 panel held that absent potential financial gain in response to the gift, no personal benefit exists.[9] [10]

After the Second Circuit's decision in *Newman*, the Supreme Court considered the scope of the personal benefit requirement in *Salman*. There, the tipper was an investment banker who provided material, nonpublic information about impending mergers to his brother who, in turn, provided the information to Salman, his brother-in-law. In affirming *Salman*'s conviction, the Court concluded that a gift of confidential information to a trading relative or friend satisfies the personal benefit requirement.[11] The Court characterized the issue presented as a "narrow" one that was "easily resolve[d]" by *Dirks*. [12] As the Court explained, "*Dirks* makes clear that a tipper breaches a fiduciary duty by making a gift of confidential information to 'a trading relative' and that rule is sufficient to resolve the case at hand."[13] According to the Court, under *Dirks*, "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."[14]

The Court explained that, to the extent that the Second Circuit's holding in *Newman* requires that the tipper receive something of a "pecuniary or similarly valuable nature" in the context of "a gift to family or friends," such a requirement is inconsistent with *Dirks*, and therefore should be rejected.[15] The Court acknowledged, as it had in *Dirks*, that "determining whether an insider personally benefits from a particular disclosure. . .will not always be easy for courts," but found no difficulty resolving that question under the facts presented in *Salman* because the case involved "precisely the gift of confidential information to a trading relative that *Dirks* envisioned."[16]

The Decision in *Martoma*

In *United States* v. *Martoma*, the defendant argued that *Salman* did not affect *Newman*'s requirement that there be a "meaningfully close personal relationship" between the tipper and tippee for a personal benefit to exist absent financial gain.[17] The defendant argued that in *Salman,* it was clear that such a relationship existed between the tipper and tippee because they were brothers, whereas no such "meaningfully close personal relationship" existed between the defendant (Martoma) and his alleged tipper in this case (a doctor involved in a clinical trial).[18]

The Second Circuit rejected these arguments and affirmed the defendant's conviction in a split panel decision. The majority (Chief Judge Katzmann and Judge Chin) concluded that a tipper can receive a personal benefit from giving a gift of inside information to another person even where there is no "meaningfully close personal relationship" between the two.[19] While *Dirks* referred to gifts of information to a "relative or friend," and *Salman* repeatedly limited its holding to those same categories of tippees, the majority held that *Dirks* was merely using this as an example of a situation in which there is a personal benefit, not as a limitation on when insider-trading liability can be imposed.[20] The majority wrote that, under *Dirks* and *Salman*, a corporate insider benefits personally when "he disclos[es] inside information as a gift . . . with the expectation that the [recipient] would trade" on that information.[21] This logic applies whether or not there is a "meaningfully close personal relationship" between the tipper and tippee.[22] The majority acknowledged that *Salman* had not explicitly overruled this aspect of *Newman*, but nevertheless concluded that *Salman* cast sufficient "doubt" on the *Newman* analysis to justify holding that *Newman*'s requirement of a "meaningfully close personal relationship" is "no longer good law."[23] The majority emphasized, however, that "not all disclosures of inside information will meet this test."[24] There must be sufficient facts from which an inference can be drawn that the information "was disclosed with the expectation that the recipient would trade on it and that the disclosure resembles trading by the insider followed by a gift of the profits to the recipient."[25]

One judge on the three-judge panel (Judge Pooler) dissented, and offered a starkly different view of the appropriate scope of insider trading liability. Judge Pooler concluded that the majority went too far in eliminating important restrictions on when the sharing of information in the absence of financial benefit is illegal. While *Salman* abrogated *Newman*'s requirement that an insider must have the potential to profit financially from a disclosure, *Newman*'s conclusion that insider trading liability based upon a gift requires a "meaningfully close personal relationship" between the tipper and tippee is fully consistent with the ruling in *Salman*.[26] Moreover, Judge Pooler wrote, this rule is logical, since tippers will typically have no "legitimate commercial reason to share business secrets with friends and family," and a personal benefit can thus be inferred from a gift to close friends or family.[27] By contrast, gifts to colleagues or acquaintances are more likely to result from "innocent conduct," so inferring a personal benefit in such situations is harder to justify.[28] By overriding *Newman*'s requirement of a "meaningfully close personal relationship," the dissent maintained, the majority had "vastly expanded" when a gift of information can support insider trading liability.[29] Because it is so difficult to know when inside information is a "gift" and when it is not, the majority's approach would result in "decision-making that is arbitrary and subjective" and would "undermine[] the objectivity and limitation that the personal benefit rule is designed to provide."[30] As a result, the dissent concluded, the personal benefit requirement would cease to serve as a meaningful limitation on insider trading liability and would no longer address the concerns articulated in *Dirks* that initially necessitated the personal benefit requirement.[31]

Discussion

The U.S. Supreme Court intended the personal benefit requirement to provide clear boundaries to guide market participants and avoid chilling legitimate communications between market professionals and company insiders. Without a statutory definition, however, or much clarity from the Supreme Court, lower courts have been left to define and apply the personal benefit requirement.

A personal benefit to the tipper clearly exists when he receives a financial benefit or *quid pro quo*. And, where an insider discloses information to a close friend or relative with whom they have no legitimate commercial reason to share business secrets, an inference of a personal benefit is often not difficult to justify. In that circumstance, the risk of sweeping in "innocent" conduct is low.

On the other hand, in the context of analysts and other market professionals, whose job functions generally require direct contact with company insiders, there are often legitimate business reasons for such communications, and an insider might disclose material, nonpublic information to a market professional without intending for it to be an improper "gift" of information. As such, as Judge Pooler recognized in her dissent, the risk of sweeping in "innocent" conduct is far greater, and the corresponding need for clear boundaries more acute, in that context.

The competing tests articulated by the panels in *Newman* and *Martoma* reflect very different approaches to this problem. In *Newman*, where the alleged tip was made to an analyst for no financial benefit, the Second Circuit developed the "meaningfully close personal relationship" standard. In *Martoma,* the Court overruled *Newman* and replaced that standard with a new test for assessing the "personal benefit" requirement: whether 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."

It will now be up to the lower courts in the Second Circuit to interpret and apply this new standard. It remains to be seen whether this new test will be effective in providing clear boundaries and preventing innocent conduct from being swept up in insider trading actions, particularly in the context of communications between company insiders and market professionals. To carry out the Supreme Court's mandate in *Dirks*, courts must treat this test as imposing a meaningful burden on plaintiffs and prosecutors rather than a hollow standard without real teeth. That means that courts will need to require real proof that a tipper believed the tippee would trade and that the tipper truly intended the disclosure to be a gift akin to sharing trading profits with the tippee. Otherwise, if courts permit generalized allegations that can be made in nearly every circumstance, such as a corporate executive trying to maintain a good relationship with a large institutional investor, the new test risks eviscerating the "guiding principle" viewed as essential by the Supreme Court and chilling the communications the Court sought to preserve in *Dirks*.

The *Newman* and *Martoma* opinions paint two different pictures of the appropriate way to determine when there is a personal benefit in the absence of a financial benefit. Given the stark contrast between the two opinions (and between the majority and dissent in *Martoma*), the importance of Second Circuit law in this area, and the unusual procedural posture involved in overruling such a recent precedent, the *Martoma* decision may be a candidate for *en banc* review by the full Second Circuit.

Conclusion

In *United States* v. *Martoma*, a divided panel of the Second Circuit overruled the court's own 2014 decision in *United States* v. *Newman,* abandoning the "meaningfully close personal relationship" test and instead creating a new test to define the boundaries of the personal benefit requirement. If the opinion withstands a potential *en banc* review, it will be up to lower courts in the Second Circuit to implement the test in a way that gives meaning to the concerns that led the Supreme Court to impose the personal benefit requirement in the first place.

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[1] *United States* v. *Martoma*, No. 14-3599, slip op. at 27–28 (2d Cir. Aug. 23, 2017).

[2] 463 U.S. 646 (1983).

[3] The Supreme Court has recognized two theories of insider trading liability: "classical" and "misappropriation." The "classical theory" of insider trading liability applies when a "corporate insider trades in the securities of his corporation on the basis of material, nonpublic information." *United States* v. *O'Hagan*, 521 U.S. 642, 651-52 (1997). The "misappropriation theory," by contrast, applies when an investor "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." *Id.* at 652.

[4] *Id.* at 664.

[5] *Id.* at 662.

[6] *Id.*

[7] 773 F.3d 438 (2d Cir. 2014).

[8] *Id.* at 452–53.

[9] *Id.* at 452.

[10] Additionally, in *Newman*, the Second Circuit addressed a related question that is not at issue in *Martoma*: whether a remote tippee is required to have knowledge of the receipt of a personal benefit by the insider. Based on its reading of *Dirks,* the Second Circuit held that "a tippee's knowledge of the insider's breach necessarily requires knowledge that the insider disclosed confidential information in exchange for personal benefit." *Id.* at 452. Going forward, it does not appear that the government intends to challenge this aspect of *Newman*.

[11] *Salman* v. *United States*, 137 S. Ct. 420, 426 (2016).

[12] *Id.* at 427.

[13] *Id.*

[14] *Id.* at 428.

[15] *Id.*

[16] *Id.* at 429.

[17] Post-Argument Letter Brief of Appellant at 1, *United States* v. *Martoma*, No. 14-3599 (2d Cir. Jan. 17, 2017).

[18] *Id.*

[19] *United States* v. *Martoma*, slip op. at 25.

[20] *Id.* at 21.

[21] *Id.* at 25 (quoting *Salman*, 137 S. Ct. at 428).

[22] *Id.* at 25–26.

[23] *See id.* at 23-24 (quoting *Doscher* v. *Sea Port Grp. Sec., LLC*, 832 F.3d 372, 378 (2d Cir.
2016).

[24] *Id.* at 29.

[25] *Id.*

[26] *United States* v. *Martoma*, dissent slip op. at 18 (Pooler, J., dissenting).

[27] *Id.* at 29–30.

[28] *See id.*

[29] *Id.* at 20.

[30] *Id.*

[31] *Id.*