

The Martoma Decision: The Second Circuit Tackles Insider Trading Post-Salman

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The decision could alter the landscape of tipping liability.

The US Court of Appeals for the Second Circuit issued another landmark insider trading opinion on August 23. In *United States v. Martoma*,^[1] the Second Circuit loosened the standard required for the government to establish tipping liability, handing the government a significant victory in this key enforcement area. *Martoma* is the latest in a string of important decisions concerning this scope of insider trading liability.

In *Dirks v. SEC*,^[2] the US Supreme Court established tipping liability, holding that a tippee can be derivatively liable for insider trading when the tipper breached 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.”^[3] The Court explained that such a benefit includes “when an insider makes a gift of confidential information to a trading relative or friend” because “[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.”^[4]

The seeds of *Martoma* were planted in the Second Circuit’s 2014 decision in *United States v. Newman*,^[5] which threw a wrench in the government’s multiyear enforcement efforts in insider trading because of the decision’s heightened standard for tipping liability. *Newman* redefined the personal-benefit standard to require a “meaningfully close relationship” that presented “at least a potential gain of a pecuniary or similarly valuable nature.”^[6] But 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 abrogated *Newman*’s personal benefit pecuniary requirement by finding—following *Dirks*—that an insider who gifts inside information to a trading relative or friend receives the requisite personal benefit.

A dispute, however, remained as to whether any gift sufficed or whether a close personal relationship in a gift-giving context was necessary to satisfy the personal-benefit requirement. *Martoma* resolves that issue, clarifying that so long as someone gifts the inside information with the expectation that the tippee will trade, the personal benefit test is met, even if the tipper and tippee are not even friends or relatives. This is a significant victory for the government.

The Newman Decision

In *Newman*, defendants Todd Newman and Anthony Chiasson were “remote” or “downstream” tippees convicted of trading on material nonpublic information (MNPI) that they received from other tippees. On appeal, the Second Circuit reversed both convictions. The court held that a tippee only knows of the tipper’s breach of fiduciary duty and is therefore potentially liable for insider trading 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”; rather, it 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]

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The *Salman* Decision

In *Salman*, defendant Bassam Yacoub Salman, a remote tippee, received and traded on MNPI from his brother-in-law Michael Kara, who had obtained the information from his older brother Maher Kara, an investment banker at a large bank. Evidence showed that Salman was aware that the MNPI originated with Maher Kara, but there was no evidence that Maher received any pecuniary benefit for his tips. Salman was convicted at trial and his conviction was upheld by the US Court of Appeals for the Ninth Circuit. The US Supreme Court granted certiorari.

The Supreme Court squarely rejected Salman's argument that an insider must receive a pecuniary quid pro quo from a tippee to establish a personal benefit. The Court observed that *Dirks* made clear that a tipper breaches a fiduciary duty—and receives a personal benefit—by making a gift of confidential information to a “trading relative or friend,” which clearly happened in that case. In applying *Dirks*, the Court held that “Maher, a tipper, provided inside information to a close relative, his brother Michael. *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.”^[10]

The Court also 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 that a personal benefit includes the benefit one would obtain from simply making a gift of confidential information to a trading relative, and, accordingly, upheld the Ninth Circuit's judgment.

The *Martoma* Case

Mathew Martoma worked as a portfolio manager at S.A.C. Capital Advisors, LLC (SAC), focusing on pharmaceutical and healthcare companies. In that role, Martoma caused SAC to acquire shares of two companies that were jointly developing an experimental drug called bapineuzumab used to treat Alzheimer's disease. Martoma obtained information about bapineuzumab from Dr. Sidney Gilman, chair of the safety monitoring committee for the bapineuzumab clinical trial, in meetings arranged by an expert networking firm. Dr. Gilman participated in approximately 43 consultations with Martoma, for some of which he was paid \$1,000 per hour. Despite his obligation to keep the results of the clinical trial confidential, Dr. Gilman disclosed test results and other confidential information to Martoma during the consultations. On July 17 and 19, 2008, in advance of a July 29, 2008 conference at which Dr. Gilman was due to present bapineuzumab test results, Dr. Gilman and Martoma met. Shortly thereafter, on July 21, 2008, SAC began to reduce its positions in the two companies at issue through short sales and options trades. On July 29, 2008, immediately following Dr. Gilman's presentation, the share prices of the two companies at issue fell significantly. The trades that SAC had made 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 September 9, 2014, following a four-week trial at which Dr. Gilman testified, Martoma was convicted. 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 (i) the evidence presented at trial was insufficient to support his conviction and (ii) the district court did not properly instruct the jury in light of the Second Circuit's decision in *Newman*. As to the sufficiency argument, Martoma argued that he and Dr. Gilman did not have a “meaningfully close personal relationship” and that Dr. 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 personal benefit holding, 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's Majority Opinion

As to Martoma's sufficiency challenge, the majority found that even though Dr. Gilman did not bill Martoma for the two July 2008 meetings at which Dr. Gilman provided Martoma with the critical bapineuzumab testing information, Dr. Gilman and Martoma maintained a quid pro quo relationship that presented the opportunity to “yield future pecuniary gain.”^[14] As to that relationship, 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 Dr. Gilman's ongoing quid pro quo relationship, where Dr. Gilman regularly disclosed confidential information in exchange for fees, a rational trier of fact could have found the essential elements of insider trading under a pecuniary quid pro quo theory.^[16]

As to *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 reasoned 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] The court thus 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]

Having concluded that *Newman*'s "meaningfully close personal relationship" requirement is no longer good law, the court considered whether the district court's jury instructions were accurate. The court held that the district court's jury instructions did not constitute obvious error, and held that even if the jury instructions were obviously erroneous, that 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 Pooler's Dissent

Judge Rosemary S. Pooler issued a lengthy dissent criticizing various aspects of the majority opinion.^[21] Judge Pooler 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."^[22] Judge Pooler reasoned that *Newman* included two holdings: (i) "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,'"^[23] and (ii) "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."^[24] Judge Pooler opined that *Salman* overturned only the second of those holdings, and she further asserted that the majority's requirement that a tipper must expect the tippee to trade on the information provided is not dispositive because that requirement always exists in tipping cases.^[25]

One thing the majority and the dissent agreed on 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."^[26]

The Decision's Implications

The *Martoma* decision is significant for several reasons. As the Second Circuit noted, "[t]his appeal is our first occasion to consider *Newman* in the aftermath of the Supreme Court's recent decision in [*Salman*]."^[27] The Second Circuit found that *Newman*'s requirement of a close relationship between tipper and tippee does not stand in light of *Salman*. Indeed, the Second Circuit clarified that so long as someone gifts the inside information with the expectation that the tippee will trade, the nature of the relationship between the tipper and the tippee does not matter. Thus, absent a rehearing en banc or grant of certiorari, the Second Circuit has provided additional gloss on the "gift theory" articulated in *Dirks*, holding that any gift suffices and focusing the relevant inquiry on whether a tipper expects that a tippee will trade on the inside information provided. Unless the panel's decision in *Martoma* is overturned, the ambiguity and limitations created by *Newman*'s personal benefit test are all but gone and *Martoma* will significantly aid the government's insider trading enforcement efforts.

[1] *United States v. Martoma*, No. 14-3599, Dkt. No. 174-1 (2d Cir. Aug. 23, 2017).

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

[3] *Id.* at 662.

[4] *Id.* at 664.

[5] 773 F.3d 438 (2d Cir. 2014).

[6] *Id.* at 452.

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

[8] 773 F.3d 438, 450.

[9] *Id.* at 452.

[10] 137 S. Ct. 420, 427.

[11] *Id.* at 428.

[12] *Martoma*, slip op. at 13.

[13] *Martoma*, slip op. at 19.

[14] *Martoma*, slip op. at 18 (quoting *Newman*, 773 F.3d at 452).

[15] *Martoma*, slip op. at 18.

[16] *Martoma*, slip op. at 18-19.

[17] *Martoma*, slip op. at 25 (internal quotations, citations, and alterations omitted).

[18] *Martoma*, slip op. at 25.

[19] *Martoma*, slip op. at 27-28 (internal quotations, citations, and alterations omitted).

[20] *Martoma*, slip op. at 35.

[21] *United States v. Martoma*, No. 14-3599, Dkt. No. 175 (2d Cir. Aug. 23, 2017) (Pooler, J., dissenting) (hereinafter, Dissent).

[22] Dissent at 2.

[23] Dissent at 11.

[24] Dissent at 13.

[25] Dissent at 20 (citing *S.E.C. v. Obus*, 693 F.3d 276, 286-87 (2d Cir. 2012); *United States v. Gansman*, 657 F.3d 85, 92 (2d Cir. 2011)).

[26] *Martoma*, slip op. at 22 n.6; Dissent at 15, 18.

[27] *Martoma*, slip op. at 3.

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