In Amended Decision, U.S. Court of Appeals (Second Circuit) Leaves Open the Ability to Prosecute Insider Trading Absent Evidence of a "Meaningfully Close Personal Relationship"

July 5, 2018

On June 25, 2018, a divided panel of the U.S. Court of Appeals for the Second Circuit issued an amended decision in *United States v. Martoma*. In its initial decision, the Second Circuit expressly overturned a key requirement for insider trading liability set out by its previous decision in *United States v. Newman.*[1] Under *Newman*, the government was required to prove a "meaningfully close personal relationship" between an individual with material non-public information (tipper) and an individual who is told and ultimately trades on that information (tippee) in order to establish the "personal benefit" element under the "gift theory" of insider trading liability. The initial *Martoma* decision held that the "meaningfully close personal relationship" requirement was no longer tenable in light of the recent Supreme Court decision in *Salman v. United States.*[2]

The Court's amended decision relies on the Supreme Court's decision in *Dirks v. SEC*[3] to find that a "personal benefit" to the tipper may be established either by examining the relationship between the tipper and tippee or by determining that the tipper intended to benefit the tippee. A "meaningfully close personal relationship" or a relationship "that suggests a *quid pro quo*" is sufficient to establish a personal benefit to the tipper. Evidence that the tipper intended to benefit the tippee is independently sufficient to establish a personal benefit. The amended decision remains a victory for prosecutors and leaves open the potential to expand insider trading liability; the continued split decision remains a potential avenue for the Second Circuit to reconsider the issue *en banc*.

Factual Background

As we previously discussed at the time of the Second Circuit's initial decision, former SAC Capital Advisors, LLC portfolio manager Mathew Martoma was convicted of conspiracy to commit securities fraud and securities fraud for trading on material, non-public information obtained from expert-network consultants about clinical drug trials. On August 23, 2017, a divided panel of the Second Circuit affirmed Martoma's conviction. In a decision authored by Chief Judge Katzmann and joined by Judge Chin, the Court held that a tipper personally benefits whenever he or she discloses inside information as a gift with the expectation that the tippee would trade on or otherwise exploit the information, regardless of the nature of the tipper-tippee relationship. The ruling was seen as a significant victory for the Government, as *Newman*'s "meaningfully close personal relationship" requirement had been a significant barrier for

[1] *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

[2] *Salman v. United States*, 137 S. Ct. 420, 196 L. Ed. 2d 351 (2016).

[3] *Dirks v. SEC*, 463 U.S. 646 (1983).

prosecutors and resulted in a number of reversed convictions and dismissed indictments. The majority's decision was sharply criticized by Judge Pooler in a 41-page dissent. Martoma subsequently filed a petition for rehearing or rehearing by the full Second Circuit *en banc*.

The Second Circuit's Amended Opinion

In its amended decision, also authored by Chief Judge Katzmann, the Second Circuit explained that "there are many ways to establish a personal benefit" and concluded it "need not decide whether *Newman*'s gloss on the gift theory is inconsistent with *Salman*." Explaining that the term "meaningfully close personal relationship" is "new to our insider trading jurisprudence" and potentially susceptible to multiple interpretations if taken in isolation, the majority read *Newman* to require evidence of a personal benefit to the tipper, which can be established through <u>either</u> evidence of a meaningfully close or *quid pro quo* relationship between tipper and tippee <u>or</u> evidence that the tipper intended to benefit the tippee by sharing confidential information.

The majority went on to explain that each of these is an independently sufficient basis for inferring that a tipper received a personal benefit as a result of his or her disclosure. The majority further explained that "a jury can often infer that a corporate insider receives a personal benefit . . . from deliberately disclosing valuable, confidential information without a corporate purpose and with the expectation that the tippee will trade on it[,]" even in the absence of a personal relationship or *quid pro quo* arrangement.

Judge Pooler's Continued Dissent

In another dissent, Judge Pooler disagreed with the majority's interpretation of *Dirks*. Judge Pooler explained that *Dirks* requires objective evidence of the relationship between the tipper and tippee, and does not allow for a freestanding inference of intent absent such evidence. Judge Pooler reasoned that allowing a personal benefit to the tipper to be demonstrated through an intent to benefit the tippee reflected "circular reasoning" and functionally eliminated the personal benefit requirement, in contravention of settled law. Judge Pooler also expressed concern about the subjectivity invited by the majority's "intent to benefit" standard and posited that a jury may convict based on "inferences about [] benefit" formed through "wobbly foundations."

Implications of the *Martoma* Amended Decision

Though the Second Circuit's amended opinion in *Martoma* backtracks from the Court's earlier holding that expressly eliminated the "meaningfully close personal relationship" requirement, the new holding still allows the Government to pursue insider trading cases under the "gift theory" even where it lacks proof of a tipper-tippee relationship, by allowing the "personal benefit" element to be independently satisfied by evidence of an "intent to benefit" a tippee. It remains to be seen whether the Second Circuit will reconsider the case *en banc*, but in the interim this amended decision appears to leave open the avenue for prosecution (re)opened by the original *Martoma* decision last year.

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