Insider Trading: U.S. Court of Appeals (Second Circuit) Upholds Convictions, Eliminates *Newman*'s "Meaningfully Close Personal Relationship" Requirement

September 5, 2017

In *United States v. Martoma* a divided U.S. Court of Appeals for the Second Circuit overturned a key holding of its previous decision in *United States v. Newman*[1] and significantly loosened the requirements of insider trading law. Under *Newman*, the government was required to prove a "meaningfully close personal relationship" between an individual with material nonpublic 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. Explaining that this "meaningfully close personal relationship" requirement was no longer tenable in light of the Supreme Court's recent decision in *Salman v. United States*,[2] the Court in *Martoma* emphasized that a corporate insider personally benefits whenever he discloses inside information as a gift with the expectation that the recipient would trade on it or otherwise exploit it for his personal benefit, irrespective of his relationship with the recipient. The decision is a victory for prosecutors and has the potential to expand insider trading liability; however, the split decision potentially sets the stage for the Second Circuit to reconsider the issue *en banc*.

Factual Background of *Martoma*

Defendant Mathew Martoma, a portfolio manager at SAC Capital Advisors, LLC, was convicted of conspiracy to commit securities fraud and securities fraud by a jury in the Southern District of New York. At trial, the Government presented evidence that Martoma paid significant consulting fees to expert physicians to receive material, nonpublic information regarding the clinical trials of an experimental treatment for Alzheimer's disease. While Martoma did not pay a fee for the specific tip he traded on—Martoma and SAC Capital significantly reduced their positions in two pharmaceutical companies when it became clear that the clinical trials would likely fail—each tipper met with Martoma several times over the course of the drug trial and charged rates of at least $1,000 per hour for the consultations.

History of *Newman* and *Salman*

In *United States v. Newman,* the Second Circuit held that satisfaction of the personal benefit element of tippee liability requires (i) that the tipper and tippee have a "meaningfully close personal relationship," and (ii) that the tipper receive something of a "pecuniary or similarly valuable nature." In *Salman v. United States,* the Supreme Court rejected this heightened standard by overturning *Newman*'s pecuniary benefit requirement and holding that a factfinder may infer that a tipper benefited from divulging nonpublic information even if the tipper's goal was not to obtain money, property, or something of tangible value. *Salman* did not explicitly address

[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).

Newman's "meaningfully close personal relationship" requirement because the tipper and tippee were brothers with an obvious close relationship.

The Second Circuit's Decision in *Martoma*

Martoma appealed his conviction and raised two key issues: (i) whether at least one tipper received a financial benefit from providing confidential information to the defendant; and (ii) whether the logic of the Supreme Court's decision in *Salman* abrogated the Second Circuit's prior decision in *Newman* that a "meaningfully close personal relationship" was required to establish liability.

In a decision authored by Chief Judge Katzmann and joined by Judge Chin, the Second Circuit held that a tipper can personally benefit from a disclosure to the tippee even if no payment is exchanged for the tip. The Court retained *Newman*'s holding that a tipper's gain need not be immediately pecuniary and emphasized that a *quid pro quo* relationship with a tippee creates an opportunity for future pecuniary gain and is sufficient to create a financial benefit.

The Court also held that *Newman's* meaningful relationship requirement improperly limited "the situations in which a personal benefit could be inferred." The Court reasoned that *Newman*'s requirement was untenable after *Salman*, which reaffirmed that a benefit can be conferred "when an insider makes a gift of confidential information to a trading relative or friend" and "the tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient." The Second Circuit held that *Salman* failed to support "a distinction between gifts to people with whom a tipper shares a 'meaningfully close personal relationship' . . . and gifts to those with whom a tipper does not share such a relationship," and overruled *Newman*'s requirement to the contrary.

The Dissent Argues that the Majority Goes Too Far

The lengthy dissent, authored by Judge Pooler, took issue with several aspects of the majority opinion. According to the dissent, the *Salman* Court specifically declined to accept a rule eliminating the close personal relationship requirement, and the *Salman* Court's repeated references to gifts of confidential information "to a trading relative or friend" were evidence of its adherence to the close relationship requirement in *Newman*. The dissent cautioned that the majority's holding has the potential to expand liability for insider trading significantly, and will cause problems in lower courts because the concept of a "gift" from which a personal benefit may be imputed is vague and subjective.

Implications of the *Martoma* Decision

Martoma removes a barrier for the government in insider trading investigations and prosecutions. *Newman* had proven a significant obstacle to insider trading prosecutions, resulting in a series of reversed convictions and dismissed indictments. The reversal of two of *Newman*'s key holdings—first in *Salman* and now in *Martoma*—may very well usher in a more aggressive era of insider trading enforcement.

The *Martoma* decision, however, may not be the last word on this case or for the "meaningfully close personal relationship" standard. The sharply-worded dissent, the fact that a panel of the Second Circuit—and not the *en banc* Court—reversed a prior panel decision, and the importance of the issue all increase the likelihood that the Second Circuit may choose to reconsider the issue *en banc*.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

New York		
Martine M. Beamon	**212 450 4262**	**martine.beamon@davispolk.com**
Angela T. Burgess	**212 450 4885**	**angela.burgess@davispolk.com**
Avi Gesser	**212 450 4181**	**avi.gesser@davispolk.com**
Denis J. McInerney	**212 450 4477**	**denis.mcinerney@davispolk.com**
Jennifer G. Newstead	**212 450 4999**	**jennifer.newstead@davispolk.com**
Northern California		
Neal A. Potischman	**650 752 2021**	**neal.potischman@davispolk.com**
Washington DC		
Neil H. MacBride	**202 962 7030**	**neil.macbride@davispolk.com**
Paul J. Nathanson	**202 962 7055**	**paul.nathanson@davispolk.com**
Linda Chatman Thomsen	**202 962 7125**	**linda.thomsen@davispolk.com**
Kenneth L. Wainstein	**202 962 7141**	**ken.wainstein@davispolk.com**