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Legal Sidebar

The Latest Chapter in Insider Trading Law: Major Circuit Decision Expands Scope of Liability for Trading on a "Tip"

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In late August, a split panel of the U.S. Court of Appeals for the Second Circuit (Second Circuit) affirmed the insider trading conviction of Mathew Martoma, a former portfolio manager at the hedge fund SAC Capital Advisors. Martoma's conviction, resulting from trades that netted the defendant and his firm millions of dollars, was part of a broader investigation in which SAC Capital itself was forced to pay $1.8 billion in the largest insider trading penalty in history. *Martoma* not only involved high dollar figures, but the Second Circuit's decision may have significant implications for insider trading law. The case is the first from the Second Circuit—an appeals court based in Manhattan and known for its securities law expertise—interpreting last year's Supreme Court decision in *Salman v. United States*. As commentators have noted, *Martoma* has raised important questions as Congress, courts, law enforcement and market participants consider what type of information sharing—and specifically, to whom—can form the basis for insider trading liability based on a "tip."

Insider Trading Liability and "Tipping"

As background, insider trading is a violation of Section 10(b) of the Securities Exchange Act and the Securities and Exchange Commission's (SEC's) Rule 10b-5, which prohibit, respectively, the "use [of] . . . any manipulative or deceptive device or contrivance" and "any act, practice, or course of business which . . . operates as a fraud or deceit" in connection with the purchase or sale of a security. In its classic form, insider trading involves corporate insiders trading securities on the basis of material, non-public information in violation of a fiduciary duty (*i.e.*, a duty of trust and confidence owed under the law) to the corporation's shareholders. Others, such as a company's lawyers, for example, can also be found guilty of insider trading if they trade on material, non-public information that they have "misappropriated" in breach of a fiduciary duty to their principal. Otherwise, market participants are generally free to trade on the basis of inside information without running afoul of Section 10(b) and Rule 10b-5, with an important exception: "tipping liability."

Tipping liability arises in a situation where the insider, instead of trading on inside information himself, acts as a "tipper" and provides inside information to a "tippee," who then, in turn, trades on that information. If the tippee knew (or should have known) that the insider or tipper breached a fiduciary duty

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in disclosing the information, the tippee may be liable for insider trading along with the tipper. Martoma's case, like a number of other significant insider trading convictions in recent years, involves trading based on a "tip."

Personal Benefit Requirement and "Gifting"

In order to conclude that a tipper breached a fiduciary duty, courts require a finding that "[the tipper] personally will benefit, directly or indirectly, from [making the] disclosure," an inquiry that is largely fact dependent. For instance, a personal benefit is most obviously found where a tipper receives monetary payment from the tippee in exchange for information. The Supreme Court in *Dirks v. SEC*, however, has also explained that a "personal benefit" can be inferred when a tipper "makes a gift of confidential information to a trading relative or friend." While perhaps not perfectly intuitive that the *giver* of a gift would be seen as receiving a benefit, *Dirks* viewed a "tip" of information to a relative or friend as not meaningfully different from the tipper trading on the information himself for cash and then gifting the proceeds to the tippee. However, *Dirks* also found it important to protect from liability those who may regularly receive material, non-public information, such as market analysts and reporters, from sources encountered in the course of their employment.

In recent years, courts have struggled to balance these considerations from *Dirks* in defining the limits of when the "gifting" inference should apply:

- In 2014, in *United States v. Newman*, the Second Circuit expressed concern that casual acquaintances could become encompassed within "gifting theory," resulting in the personal benefit requirement having little "consequence." Accordingly, *Newman* articulated a relatively strict test, holding that a "gift" of inside information could not serve as the basis for an insider trading conviction absent "proof of 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" for the tipper.
- Two years later, in *Salman v. United States*, the Supreme Court upheld a defendant's conviction for insider trading based on inside information obtained from his brother-in-law. *Salman* addressed—and rejected—certain language from *Newman*. Specifically, the Supreme Court made clear that a potential gain of a "pecuniary or similarly valuable nature" to the tipper is *not* necessary for the "gifting theory" to apply, reaffirming *Dirks'* statement that a tip that is provided to a "friend or relative" can form the requisite inference of a personal benefit. The Court, however, perhaps because the relationship at issue in *Salman* fell squarely within *Dirks'* "friend or relative" language, did not explicitly address the "meaningfully close relationship" requirement from *Newman*.

***Martoma* and Its Implications for Insider Trading Law**

Martoma focused his argument on appeal on *Newman's* "meaningfully close relationship" requirement. Martoma contended that he did not have such a relationship with his tippers, two doctors working on the clinical trial for a drug being developed by two pharmaceutical companies. In his role as a portfolio manager covering healthcare and pharmaceutical stocks for SAC Capital, Martoma regularly met with the doctors, who divulged confidential information regarding the drug. Martoma, in turn, used the information to profit in subsequent transactions involving those pharmaceutical companies' stock.

The Second Circuit rejected Martoma's argument, concluding that the "meaningfully close relationship" requirement was untenable in light of the Supreme Court's fundamental changes to the *Newman* analysis in *Salman*, including its reaffirmation of the logic in *Dirks*. Adding another wrinkle to this already complicated area of law, the majority articulated a new test for finding a personal benefit in the case of gifting a tip—one which dispenses with any "friend or relative" requirement altogether. In a clear departure from *Newman*, *Martoma* held that a personal benefit could be inferred if the tip is made to *anyone* "whenever the information was disclosed with the expectation that [the recipient] would trade on it and the disclosure resemble[s] trading by the insider followed by a gift of the profits to the recipient." The majority reasoned as such because of *Dirks'* conclusion that a tip to a friend or relative was not meaningfully distinguishable from a cash gift for purposes of insider trading liability. Building on this rationale, the court explained that, for example, a tenant's "gift" of information to his doorman in lieu of a year-end gratuity should be a basis for liability as well. As raised in dissent in *Martoma*, the standard set forth by the majority has the potential to vastly expand the gifting theory's use—and insider trading liability—based on an insider or tipper's sharing of information with a range of tippees, such as acquaintances, colleagues, or even strangers. The court's expansive view has since been called a "boon to prosecutors" by some reporters, and comports with one of the government's arguments in *Martoma* that the depth of a friendship should not matter where one has disclosed information to another without legitimate corporate purpose in violation of a fiduciary duty.

Going forward, Martoma has asked to have his case reheard by the entire Second Circuit, arguing that the August decision inappropriately overruled the "meaningfully close relationship" requirement from *Newman* and misconstrued the Supreme Court's decision in *Salman*. In particular, Martoma contends that the panel's expansion of the gifting theory essentially nullifies the personal benefit requirement, because all information sharing (with the expectation that the recipient will trade on that information) could now potentially be seen as a "gift." Two outside groups have argued in support of Martoma's motion, contending that the *Martoma* standard for when a tip will be considered a "gift" is vague and subjective, leaving juries with the difficult and confusing task of "divining" the mental states of both the tipper and tippee. The Second Circuit's decision as to whether it will rehear the case is pending. If the Second Circuit declines to rehear the case, Martoma may still choose to file a petition for a writ of certiorari to the Supreme Court.

In the meantime, *Martoma* could be of interest to those in Congress with concerns about clarifying the scope of insider trading liability, which has developed over the years solely through the courts. For example, after the Second Circuit's *Newman* decision, several insider trading bills were introduced in the 114th Congress (H.R. 1173, H.R. 1625, and S. 702). While some, including several federal judges, have periodically called upon Congress to legislate in this area, SEC Chairman Jay Clayton recently remarked that he does not believe there is a need for such a statute, satisfied with the SEC's ability to punish wrongdoers under current law.

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