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Cui Bono? The (Latest) Personal Benefit Test in Insider Trading Cases

In the last four years, the Federal Courts of Appeal and the Supreme Court have addressed the significant question of what constitutes a personal benefit in determining whether an insider has breached a fiduciary duty in insider trading tipping cases. After taking a circuitous route, it appeared for a time that the law ended up exactly where it started thirty-five years ago, with the Supreme Court decision, *Dirks v. SEC*.[1] However, a subsequent pair of Second Circuit split decisions (in the same case!) have put the law on personal benefit back in play.

DIRKS FOR DECADES

In *Dirks*, the Supreme Court held that the test for determining whether an insider has breached a fiduciary duty is "whether the insider personally will benefit, directly or indirectly, from his disclosure."[2]

In addition to those clear-cut cases where a pecuniary benefit is actually exchanged, the *Dirks* Court found that "the elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend"[3] because the tip and trade resemble trading by the insider himself followed by a gift of the profits to the tippee. As the Supreme Court stated, the test articulated in *Dirks* created "a guiding principle for those whose daily activities must be limited and instructed by the SEC's inside-trading rules."[4]

NEWMAN'S HEIGHTENED REQUIREMENT

Despite the long-standing precedent of *Dirks* as to what constitutes a personal benefit in tipping cases, the Second Circuit's 2014 decision in *United States v. Newman*[5] added an additional, heightened requirement. There, the Second Circuit held that in order to establish that the insider received a personal benefit by disclosing confidential information to a trading relative or friend, the government must prove that the insider and the tippee have "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."[6] In reversing the

convictions of two hedge fund managers who received nonpublic corporate earnings information as remote tippees, the *Newman* Court found that the original tipper and tippee did not have a close relationship but were merely casual acquaintances—even though they had known each other for years and had been classmates.[7] As such, the court held there was insufficient evidence to prove the insider received a personal benefit when he disclosed the information to the tippee.

SALMAN'S RETURN TO DIRKS

Following *Newman*, the Supreme Court in *Salman v. United States*[8] reemphasized its earlier holding in *Dirks* that a personal benefit can be inferred where a tipper makes a gift of inside information to a trading relative or friend.

In *Salman*, defendant Bassam Yacoub Salman traded on material nonpublic information he received from his brother-in-law, who, in turn, obtained the information from his investment banker older brother. Evidence at trial showed that Salman was aware the information originated with the investment banker—his tipper's brother; therefore, he was aware the tipper received a personal benefit by doing so. The court did not go further, stating: "To the extent the Second Circuit held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends, . . . this requirement is inconsistent with *Dirks*.'" [9]

Because *Salman* involved tipping between brothers who had a close relationship, the court did not address *Newman's* "meaningfully close personal relationship" standard.

Two decisions issued shortly after *Salman* found the following relationships sufficient to satisfy the personal benefit requirement (in the absence of an exchange of something of pecuniary value): (1) members of same country club and friends for fifteen years,[10] and (2) close friends from the financial industry and business school.[11] In *United States v. Bray*, the First Circuit affirmed Robert Bray's conviction for insider trading after he received material nonpublic information about a local bank from a fellow country club member and then used that information to make a substantial trading profit.[12] The First Circuit found the government presented sufficient evidence for a reasonable jury to conclude that Bray and the tipper had a close relationship, after the tipper testified that the two had known each other for fifteen years and were good friends.[13]

In the second of these cases, *Rajaratnam v. United States*, the District Court for the Southern District of New York applied the *Salman* decision to a § 2255 habeas petition filed by Raj Rajaratnam. Rajaratnam, the former founder and manager of the Galleon Group, received material nonpublic information from, *inter alia*, two intermediaries, who, in turn, received the information from corporate insiders. The basis of Rajaratnam's habeas petition was that he was innocent of those counts in which he did not personally provide benefits to the insiders, on the grounds that there was no evidence that he knew the insiders tipped in exchange for a benefit. The district court denied Rajaratnam's claim of actual innocence finding that in all the counts at issue: (1) the confidential information transferred between trading relatives or friends, and therefore, the transfer of the inside information alone was sufficient to constitute the benefit;[14] and, (2) Rajaratnam, only one level removed from the insider, had knowledge that the inside information was tipped between friends and therefore conferred in exchange for such benefit.[15]

In these decisions, the courts cited to *Salman* and *Dirks* for the principle that, in the absence of the exchange of something of a pecuniary value, a personal benefit can be inferred where a tipper makes a gift of inside information to a trading relative or friend.

At this point, it appeared as the though the law, despite *Newman's* zig, had zagged via *Salman* back to where it had been for the three decades following *Dirks*. Enter *Martoma*.

MARTOMA I AND *II*

In August 2017—less than one year after *Salman*—the Second Circuit in *United States v. Martoma* (*Martoma I*), stated that in light of that decision, *Newman's* "'meaningfully close personal relationship' requirement can no longer be sustained" and is "no longer good law."[16]

Martoma was a portfolio manager at SAC Capital Advisors LP who purchased shares in two companies developing an experimental drug after receiving nonpublic information from a doctor associated with the drug's clinical trial. Martoma was convicted of insider trading after a four-week trial at which the doctor testified. He subsequently appealed, arguing, *inter alia*, that he and the doctor did not have the requisite "meaningfully close personal relationship" under *Newman*, and that the doctor did not receive compensation in exchange for the key trial information.

In affirming Martoma's conviction, the court, relying on *Dirks* and *Salman*, 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 'resemble[s] 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."[17]

While the Eastern District of New York recognized that the Second Circuit in *Martoma I* "emphatically restored the *Dirks* 'gift-theory' regime,"[18] *Martoma I* appeared to be broader in that it suggested that *any* gift of insider information given with the expectation that the recipient will trade on it is sufficient to satisfy the personal benefit requirement in determining whether an insider has breached a fiduciary duty. Indeed, although the *Martoma I* court stated that its decision "does not eliminate or vitiate the personal benefit rule,"[19] its decision has raised concerns, as expressed by Judge Rosemary Pooler's dissent, whether the personal benefit rule now has any limitations at all.[20] Judge Pooler stated, "By holding that someone who gives a gift *always* receives a personal benefit from doing so, the majority strips the long-standing personal benefit rule of its limiting power" and "radically alters insider-trading law for the worse."[21]

Martoma subsequently asked for a rehearing. In late-June 2018, the same split Second Circuit panel affirmed the district court's judgment of conviction but dialed back its previous decision in an amended and superseding opinion—*Martoma II*.[22] The majority stated that *Salman* did not necessarily void *Newman's* meaningfully close personal relationship requirement: "Because there are many ways to establish a personal benefit, we conclude that we need not decide whether *Newman's* gloss on the gift theory is inconsistent with *Salman*."[23] The majority went on to state that it interprets *Dirks* to hold that the personal benefit element is satisfied when the tipper intends to benefit the tippee or makes a gift of confidential information to a trading relative or friend. In attempting to reconcile *Newman* with its understanding of *Dirks*, the majority noted that "immediately after introducing the 'meaningfully close personal relationship' concept, *Newman* held that it 'requires evidence of 'a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter],'" which cabined the gift theory.[24]

Both of Martoma's appeals focused to some extent on the jury instructions at his trial. *Martoma II* found that the instructions were in fact erroneous because they allowed the jury to find a personal benefit solely on the basis that the tipper tipped in order to "develop[] or maintain[] . . . a friendship."[25] According to the panel, "Under *Newman*, this articulation of the gift theory is incomplete."[26] While proper instructions do not require jurors to find a "meaningfully close" relationship (as asserted by Martoma), they do require the jurors to find a relationship with a *quid pro quo* or intention to benefit the tippee.[27] Even though the jury instructions fell short of *Newman*, the court found the error did not affect Martoma's substantial rights as the government proved one tipper received sizable consulting fees—compelling evidence that there was a *quid pro quo* relationship—as well as a personal benefit by disclosing inside information intending to benefit Martoma.[28]

Judge Pooler dissented once more in *Martoma II*, arguing that the majority's amended decision was still at odds with Supreme Court and Second Circuit precedent. In particular, Judge Pooler disagreed that, under *Dirks*, evidence of an

"intention to benefit" can alone satisfy the personal benefit element without the requisite relationship between the insider and the tippee.[29] Judge Pooler also reiterated her concern that there is no limiting factor if objective evidence is not required to prove a personal benefit.[30] Echoing the concerns raised in *Dirks*, Judge Pooler contended:

> Absent objective evidence . . . [t]he difference between guilty and innocent conduct would be a matter of speculation into what a tippee knew or should have known about the tipper's intent. A trader, journalist, or analyst attempting to avoid running afoul of criminal law would have little to guide her behavior.[31]

WHAT'S NEXT?

Only time will tell how *Martoma II* will impact the law on personal benefit. It is not altogether clear if the evidentiary burden has been lightened, but it does seem to have shifted from a focus on facts and circumstances related to the nature of a relationship to those establishing the tipper's state of mind.[32] Yet, while not required to, prosecutors may still have to rely on the nature of the relationship between the tipper and tippee to prove the insider's motives.

Should Martoma seek a rehearing *en banc*, the Second Circuit may take the opportunity to clarify the seemingly fluid contours of insider trading law in the Circuit, and in other Circuits that look to it for guidance as the home of Wall Street.

The recent back and forth has some suggesting it is past time for Congress to act to clarify the law. Southern District of New York Judge Jed Rakoff, who, while sitting by designation, authored the Ninth Circuit's opinion in *Salman*, has lamented: "The United States, by failing to recognize, unlike most other developed countries, that a meaningful effective straightforward, simple ban on insider trading is best achieved through statute rather than judge made law, has created unnecessary uncertainty and difficulty in dealing with the problem of insider trading."[33] Notably, the new Chairman of the SEC—Jay Clayton—does not see Congressional action as the answer, remarking late last year: "Some places that have a code-based insider-trading regime, my sense is [that] it doesn't work any better and in fact it's probably not as effective as our regime."[34]

Until and unless the full Second Circuit clarifies the import of *Martoma II* or Congress passes a statute, "those whose daily activities must be limited and instructed by the SEC's inside-trading rules"[35] must remain vigilant.

[1] *Dirks v. SEC*, 463 U.S. 646 (1983).
[2] *Id.* at 662.
[3] *Id.* at 664.
[4] *Id.*
[5] *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).
[6] *Id.* at 452. The court also held that the government must prove that the tippee knows of the tipper's breach of duty: "he knew the information was confidential and divulged for personal benefit." *Id.* This holding was not disturbed by *Salman.*
[7] *Id.* at 451-52.
[8] *Salman v. United States*, 137 S. Ct. 420 (2016).
[9] *Id.* at 428.
[10] *United States v. Bray*, No. 16-1579, 017 U.S. App. LEXIS 5109 (1st Cir. Mar. 22, 2017)
[11] *Rajaratnam v. United States*, 5 Civ. 5325, 2017 U.S. Dist. LEXIS 30726 (S.D.N.Y. Mar. 3, 2017), *aff'd*, 2018 U.S. App. LEXIS 14812 (2d Cir. 2018).
[12] No. 16-1579, 017 U.S. App. LEXIS 5109 (1st Cir. 2017).
[13] *Id.*
[14] *Id.* at *13.
[15] *Id.* at *15.
[16] *United States v. Martoma*, 869 F.3d 58, 69 (2d Cir. 2017), opinion amended and superseded, No. 14-3599, 2017 WL 9620394 (2d Cir. June 25, 2018).
[17] *Id.* at 70 (quoting *Salman*, 137 S. Ct. at 428; *Dirks*, 463 U.S. at 664).
[18] *Daws v. United States*, 17-cv-6668, 2018 U.S. Dist. LEXIS 8201, at *28 (E.D.N.Y. Jan. 3, 2018); s*ee also id.* at *22 (In denying an application to vacate an insider trading plea, the court acknowledged that the petitioner's plea had satisfied the *Dirks* gift theory, as the petitioner had "been aware of the close relationship between [the tipper] and [first-level tippee] and understood that it was questionable at best for [the tipper] to be sharing sensitive information with his 'best friend' who in turn might use it to make trading decisions.)
[19] *Martoma*, 869 F.3d at 71.
[20] *Id.* at 83 (Pooler, J., dissenting).
[21] *Id.*
[22] *United States v. Martoma*, 14-cr-3599, 2017 WL 9620394 (2d Cir. June 25, 2018) ("*Martoma II*"); *see also* Order to Vacate, *Martoma II* (2nd Cir. June 25, 2018), ECF No. 225.
[23] *Martoma II* at *4.
[24] *Id.* at *9.
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id.* at *2.
[29] *Id.* at *12 (Pooler, J., dissenting).
[30] *Id.*
[31] *Id.*
[32] One thing that is clear is that conscious avoidance (disguised as ignorance) of the circumstances of the disclosure will not protect tippees from liability. Southern District of New York Judge Rakoff, in a 2016 decision denying defendants' post-trial motions, held that remote tippees are unable to escape liability by consciously avoiding learning the circumstances by which confidential information had been obtained. *SEC v. Payton*, 219 F. Supp. 3d 485, 492 (S.D.N.Y. 2016). This decision was recently affirmed by the Second Circuit. *SEC v. Payton*, 17-cv-290 (2d Cir. 2018).
[33] Carmen Germaine, Rakoff Urges Securities Bar to Write Insider Trading Law, LAW360 (Mar. 1, 2017).
[34] Dave Michaels, No Law Needed on Insider Trading, SEC Chief Says, WALL ST. J. (Sept. 6, 2017).
[35] *Dirks v. SEC*, 463 U.S. 646, 664 (1983).