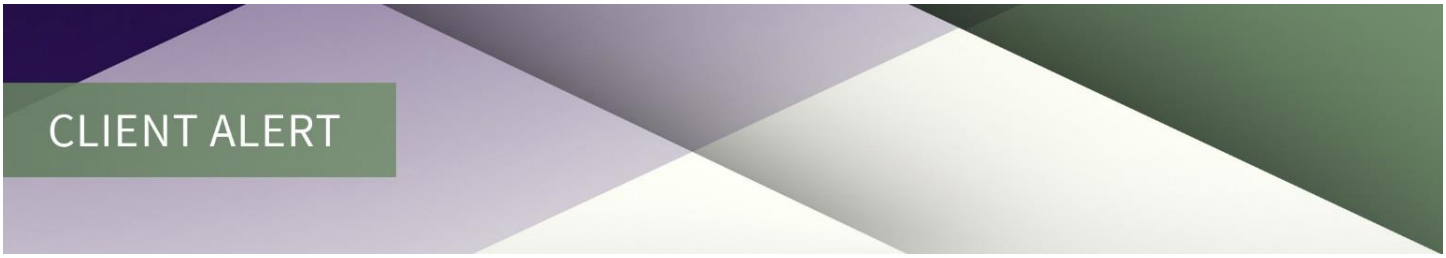

"Meaningfully Close Personal Relationship" Test Survives, But Perhaps in Name Only: Second Circuit Waters Down *Newman's* Test

June 26, 2018

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A panel of the Second Circuit yesterday amended its earlier decision in *United States v. Martoma* to interpret and water down the Second Circuit's earlier *Newman* decision rather than expressly reject it. The panel's original decision was sharply critical of *Newman* and held that it was implicitly abrogated by the Supreme Court's decision in *Salman v. United States*. In *United States v. Newman*, the Second Circuit had held that a jury cannot infer the requisite personal benefit to an insider who tipped a friend or relative absent "proof of a meaningfully close personal relationship [between tipper and tippee] that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[1] In its original decision issued on August 23, 2017, the *Martoma* panel departed from *Newman* by ruling that in an insider trading prosecution, the government need not prove a "meaningfully close personal relationship" between the tipper and tippee as long as the evidence shows that the tipper expected the tippee to trade.[2]

1 773 F.3d 438, 452 (2d Cir. 2014).

2 *United States v. Martoma*, No. 14-3599, slip op. at 27-28 (2d Cir. Aug. 23, 2017) (holding 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,'" regardless of whether there was a meaningfully close personal relationship between tipper and tippee) (quoting *Salman v. United States*, 137 S. Ct. 420 (2016)).

The panel reasoned that the Supreme Court decision in *Salman v. United States*[3] implicitly abrogated *Newman*'s meaningfully close personal relationship test. After the defendant filed a petition for a rehearing *en banc*, the panel issued an amended opinion addressing some of the petition's arguments. In its amended decision issued yesterday, the *Martoma* panel found that it was not necessary to decide whether *Salman* abrogated *Newman*'s "meaningfully close personal relationship" test, and instead held that the test can be satisfied by a showing that the relationship between the tipper and tippee suggests (1) that the tip was part of a *quid pro quo* or (2) that the tipper intended the tip to benefit the tippee.[4] By permitting the existence of a "meaningfully close personal relationship" to be established through evidence that a tipper merely intended to benefit the tippee, the panel watered down the requirement so significantly that it can no longer be deemed a meaningful hurdle to prosecution.

Background on Insider Trading Law

Insider trading liability arises from Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"). Under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, individuals who receive material nonpublic information from an issuer or other source of information to which they owe a duty of trust and confidence may not trade while aware of that information without proper disclosure. Such individuals ("tippers") also are prohibited from tipping inside information to others ("tippees") for trading. If the tippee receives a tip from the tipper, and the tippee is aware that the tip is inside information disclosed in breach of a fiduciary duty but trades anyway, then the tippee may be held liable for insider trading.

In *Dirks v. SEC*, the Supreme Court addressed the liability of an analyst who received material nonpublic information about possible fraud at a company from one of the company's former officers. The analyst relayed that information to some of his clients, who then sold their shares. In dismissing the SEC's case against the analyst for aiding and abetting securities fraud, the Court articulated the general principle of tipping liability where a tippee trades on material nonpublic information received from a company insider or misappropriator. The Supreme Court held that the mere disclosure of material, nonpublic information by itself is insufficient to constitute a breach of an insider's fiduciary duties.[5] Rather, to determine whether an insider breached a fiduciary duty, courts are required to examine the tipper's motivation for the disclosure by asking "whether the [tipper] personally will benefit, directly or indirectly, from his disclosure" to the tippee.[6] A sufficient personal benefit, the Court explained, may include "pecuniary gain or a reputational benefit that will translate into future earnings," such as where the "relationship between the insider and the recipient . . . suggests a *quid pro quo* from

[3] 137 S. Ct. 420 (2016).

[4] *United States v. Martoma*, No. 14-3599, Am. Slip Op. at 14, 30-31 (2d Cir. June 25, 2018).

[5] *Dirks v. SEC*, 463 U.S. 646, 660 (1983).

[6] *Id.* at 662.

the latter, or an intention to benefit the particular recipient."[7] The Court stated that "[t]he 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."[8]

Newman's "Meaningfully Close Personal Relationship" Test

In *United States v. Newman*, the Second Circuit heightened the standard for what constitutes a "personal benefit" under the *Dirks* test when the tip is made by a friend or relative, and held that mere friendship between tipper and tippee, without a *quid pro quo*, is insufficient to establish a personal benefit to the tipper. The court held that although a "personal benefit is broadly defined" and may include a reputational benefit or the benefit one would receive for making a gift of confidential information to a friend, it is not limitless and requires more than "the mere fact of friendship."[9] Rather, a personal benefit "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].'"[10] The court noted that if "the Government was allowed to meet its burden by proving that two individuals were alumni of the same school or attended the same church, the personal benefit requirement [from *Dirks*] would be a nullity."[11] The *Newman* court held that a personal benefit to the tipper can only be inferred where there is "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."[12]

The *Newman* court also held that the government must prove that the tippee knew that the tipper disclosed the information in breach of a duty and in exchange for a personal benefit. In defining the elements of tippee liability, the court held that "the Government must prove . . . beyond a reasonable doubt" that "the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit. . . ."[13] The court expressly rejected the government's argument that "knowledge of a breach of the duty of confidentiality without knowledge of the personal benefit is sufficient to impose criminal liability."[14]

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7 *Id*. at 663-64.

8 *Id.* at 664.

9 773 F.3d 438, 452 (2d Cir. 2014) (citation and internal quotation marks omitted).

10 *Id*. (citation omitted).

11 *Id*.

12 *Id*.

13 *Id*. at 450.

14 *Id*. at 448.

The Supreme Court's Decision in *Salman*

In *Salman v. United States*, the Supreme Court held that a tipper who gives inside information to a relative or friend "benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds."[15] The Supreme Court added that to the extent that *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 . . . this requirement is inconsistent with *Dirks*."[16]

The Second Circuit's Original and Amended Decisions in *Martoma*

In the *Martoma* case, defendant Martoma was accused of trading on inside information about clinical trials involving an Alzheimer's drug known as bapineuzumab, which was being jointly developed by the pharmaceutical companies Elan and Wyeth.[17] Through an expert networking firm, Martoma was put in touch with Dr. Sidney Gilman, who was chair of the safety monitoring committee for the bapineuzumab clinical trial.[18] Martoma and Dr. Gilman held 43 consultations with one another, with Dr. Gilman being paid about $1,000 per hour.[19] In those consultations, Dr. Gilman shared confidential information about the clinical trials with Martoma.[20]

Additionally, in advance of a July 2008 medical conference during which Dr. Gilman presented detailed results of Phase II of the clinical trial, Dr. Gilman shared the results with Martoma by phone.[21] Martoma then flew from New York to Michigan to meet with Dr. Gilman the day after that phone call.[22] At the in-person meeting, Dr. Gilman showed Martoma a PowerPoint presentation containing the Phase II results and discussed the results in detail.[23] Martoma then traded Elan and Wyeth securities in advance of the public disclosure of the results at the July 2008 medical conference.[24] Dr. Gilman was not paid specifically for the telephone call and in-person meeting in which he discussed his upcoming presentation.[25]

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15 *Salman v. United States*, 137 S. Ct. 420, 428 (2016).

16 *Id*. (internal citation omitted).

17 *Martoma*, June 2018 amended slip op. at 7.

18 *Id.* at 7-8.

19 *Id*. at 8.

20 *Id*.

21 *Id.* at 9-10.

22 *Id.* at 10.

23 *Id.*

24 *Id.*

25 *Id*. at 35-36.

On appeal, Martoma argued that he and Dr. Gilman did not have a "meaningfully close personal relationship," as required by *Newman*, and that the jury instructions at his trial were inadequate because they did not inform the jury of *Newman*'s limitations on the personal benefit element.[26]

In its original decision issued in August 2017, the panel first held that the evidence was sufficient to convict Martoma under the pecuniary *quid pro quo* theory because "Dr. Gilman regularly disclosed confidential information in exchange for fees."[27] The court then turned to Martoma's challenge to the jury instructions and determined that, in light of the Supreme Court's logic in *Salman*, the "meaningfully close personal relationship requirement can no longer be sustained."[28] The court reasoned that "*Newman* held that the jury was *never* permitted to infer that a tipper had personally benefitted from disclosing inside information as a gift unless that gift was made to someone with whom the tipper had 'a meaningfully close personal relationship.'"[29] But, the court explained, the examples provided in *Dirks* did not support such a categorical rule, particularly in light of *Dirks's* reasoning that "the justification for construing gifts as involving a personal benefit is that '[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.'"[30] Although the court acknowledged that *Salman* did not expressly overrule *Newman* because the "meaningfully close personal relationship" test was not at issue in *Salman*, it nevertheless determined that "*Salman* fundamentally altered the analysis underlying *Newman*'s 'meaningfully personal close relationship' requirement," such that this requirement "is no longer good law."[31]

In its amended decision, the *Martoma* panel interpreted and watered down *Newman* instead of holding that it was abrogated by *Salman*.[32] The panel explained that "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*."[33] The panel held that the meaningfully close personal relationship test is satisfied – and that a gift of confidential information may constitute a personal benefit – where (1) the "tipper and tippee shared a relationship suggesting a *quid pro quo*" or (2) "the tipper gifted confidential information with the intention to benefit the tippee."[34] The amended decision also favorably

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26 *Id.* at 5.

27 *Martoma*, August 2017 slip op. at 18-19.

28 *Id.* at 19-20.

29 *Id.* at 22.

30 *Id.* at 22-23 (quoting *Dirks*, 463 U.S. at 664).

31 *Id.* at 23-24.

32 *Martoma*, June 2018 amended slip op. at 14, 30-31.

33 *Id*. at 14.

34 *Id*. at 5-6; *see also id*. at 32 ("A properly instructed jury would have been informed that it could find a personal benefit based on a 'gift of confidential information to a trading relative or friend' only if it also found that Dr. Gilman and Martoma shared a relationship suggesting a *quid pro quo* or that Dr. Gilman intended to benefit Martoma with the inside information").

references *Newman*'s holding that the tippee must be aware that the tipper received a personal benefit, calling that holding an "important teaching of *Newman*" that the *Newman* court "persuasively explained. . . ."[35]

Implications of the Amended *Martoma* Decision

Without stating that it is abrogating the "meaningfully close personal relationship" requirement for tipping cases involving friends and family, the panel effectively accomplished the same thing. In its original opinion, the panel stated that a personal benefit to the tipper was established any time the evidence proves that the tip was provided with the expectation that the tippee would trade and resembles a gift of the profits to the tippee, and declared the "meaningfully close personal relationship" test a nullity. In its amended opinion, it declined to expressly reject the test, but by saying that it is satisfied merely by showing that the tipper intended to benefit the tippee, the panel accomplished the same objective as it had in its original opinion and has removed it as a meaningful hurdle to prosecution.

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[35] *Id*. at 28.