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CLIENT ALERT

Second Circuit Eliminates "Meaningfully Close Personal Relationship" Test

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The Second Circuit yesterday reversed its own precedent by ruling that in an insider trading prosecution, the government need not prove a "meaningfully close personal relationship" between the tipper and tippee. Previously, in *United States v. Newman*, the Second Circuit held that a jury cannot infer the requisite personal benefit to an insider who tipped another 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] Yesterday, however, in *United States v. Martoma*, the court reasoned that last year's Supreme Court decision in *Salman v. United States*[2] implicitly abrogated *Newman*'s meaningfully close personal relationship test. The *Martoma* court instead 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,'" regardless of whether there was a meaningfully close personal relationship between tipper and tippee.[3]

1 773 F.3d 438, 452 (2d Cir. 2014).
2 137 S. Ct. 420 (2016).
3 *Martoma*, slip op. at 27-28 (quoting *Salman*, 137 S. Ct. at 427-28).

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.[4] 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.[5] 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 the latter, or an intention to benefit the particular recipient."[6] 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."[7]

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, 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."[8] Rather, a personal benefit "requires evidence of 'a

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

[5] *Id.* at 662.

[6] *Id.* at 663-64.

[7] *Id.* at 664.

[8] *United States. v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014) (internal quotation marks omitted).

relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter].'"[9] 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."[10] 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."[11]

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[.]"[12] 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."[13]

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."[14] 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*."[15] However, as *Martoma* acknowledges, "the Supreme Court did not have occasion to expressly overrule *Newman's* requirement that the tipper have a 'meaningfully close personal relationship' with a tippee to justify the inference that a tipper received a personal benefit from his gift of inside information . . . because that aspect of *Newman* was not at issue in *Salman*[.]"[16]

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Id.* at 450.

[13] *Id.* at 448.

[14] *Salman v. United States*, 137 S. Ct. 420, 428 (2016).

[15] *Id.*

[16] *Martoma*, slip op. at 23.

The Second Circuit's Reversal of *Newman* 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]

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]

The court 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

[17] *Id.* at 4.
[18] *Id.* at 5.
[19] *Id.*
[20] *Id.* at 5-6.
[21] *Id.* at 6-7.
[22] *Id.* at 7.
[23] *Id.*
[24] *Id.*
[25] *Id.* at 18.
[26] *Id.* at 13.
[27] *Id.* at 18-19.
[28] *Id.* at 19-20.

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 it is typically "neither appropriate nor possible for [a panel] to reverse an existing Circuit precedent," a three-judge panel may do so "where an intervening Supreme Court decision casts doubt on the prior ruling."[31] Thus, 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."[32]

As a result, the court 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."[33] The court limited the scope of liability implicated by its holding, however, to "the insider who discloses inside information to someone *he expects will trade on the information*."[34]

In explaining the import of its holding, the court noted that "our holding does not eliminate or vitiate the personal benefit rule; it merely acknowledges that it is *possible* to personally benefit from a disclosure of inside information as a gift to someone with whom one does not share a 'meaningfully close personal relationship.'"[35]

Implications of *Martoma*

The *Martoma* panel has made unequivocal what had previously been unclear—the extent to which *Newman* survived the Supreme Court's ruling in *Salman*. The *Martoma* decision clarifies that *Newman*'s "meaningfully close personal relationship" test is no longer good law. This no doubt eases the government's burden in insider trading cases by no longer requiring the government to prove such a relationship between tipper and tippee. In practice, however, most insider trading cases brought by the government involve the types of relationships that would have satisfied *Newman*,

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[29] *Id.* at 22.

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

[31] *Id.* at 23 (quotations omitted).

[32] *Id.* at 23-24.

[33] *Id.* at 27-28 (quoting *Salman*, 137 S. Ct. at 427-28).

[34] *Id.* at 28.

[35] *Id.* at 29-30.

such as the sibling relationship in *Salman*. Additionally, *Martoma* did not disturb *Newman's* holding that the government must prove beyond a reasonable doubt that the tippee knew that the tipper disclosed the information in breach of a duty and in exchange for a personal benefit.

The book may not be closed on *Newman's* meaningfully close personal relationship test, however; because *Martoma* conflicts with *Newman* and drew a lengthy dissent, the Second Circuit may decide to rehear the *Martoma* case *en banc*, and the case could even provide cause for the Supreme Court to speak again on the issue.

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