Roger Williams University Law Review

Volume 24 | Issue 1 Article 2

Winter 2019

The Second Circuit's Curious Journey Through the Law of Tippee Liability for Insider Trading: Newman to Martoma

Andrew C. Spacone
Roger Williams University School of Law

Articles

The Second Circuit's Curious Journey Through the Law of Tippee Liability for Insider Trading: *Newman* to *Martoma*

Andrew Carl Spacone*

INTRODUCTION

Federal securities regulation presents a daunting challenge for those who are touched by it. The governing principles are myriad, complex, and can be ambiguous; the civil and criminal penalties for violations can be severe. Even where well intentioned, federal securities law can sweep broadly to ensnare even those who engage in legitimate practices. Insider trading law is one aspect of federal securities regulation that amply illustrates this point. The critical stakeholders in this area of the law are the federal government—in particular the U.S. Securities and Exchange Commission (SEC) and the Department of Justice (DOJ)—and, on the receiving end of the law for purposes of this Article, the securities industry.

This Article focuses on one form of insider trading law: "tippee" liability, which imposes liability on recipients of material non-public information (MNPI) who purchase or sell securities while in possession of such information.[1] This area of insider trading law is

* Professor Spacone is the Assistant Visiting Professor of Business Law, Roger Williams University School of Law. His legal experience includes

confusing and can lead to uncertain and often ambiguous outcomes. This is amply demonstrated by the current state of tippee liability law in the United States Court of Appeals for the Second Circuit. This Article will center on two recent important cases for the government and the securities industry: *United States v. Newman*,[2] and *United States v. Martoma* (the *Martoma* cases).[3]

These cases dealt with the personal benefit rule as a prerequisite for tippee liability in the "gift-giving" context involving "friends."[4] In a matter of three years, these cases, which involved similar fact patterns, reached divergent outcomes while relying largely on the same U.S. Supreme Court precedent to justify their core propositions.[5] There is nothing particularly unusual about panels interpreting precedent differently—even panels in the same circuit. The Second Circuit's struggles over where to draw the line between legal and illegal trading of MNPI within the framework of controlling Supreme Court precedent and its own contemporary case law, however, are particularly noteworthy.

The objectives of this Article are modest. First, this Article will present and discuss the cases in such a way that the reader—especially law students—can get a good sense of how courts, even one as admired as the Second Circuit, can sometimes struggle when faced with ambiguous fact patterns and unclear statutory guidance. These cases are complex and intricate. Boiling them down to their essential components runs the inevitable risk of not doing them

---

outside practice with two major law firms, and thirty years inside practice with a Fortune 300 company, Textron Inc., which he retired from as Deputy General Counsel & Assistant Secretary and head of the litigation group. Professor Spacone would like to acknowledge the invaluable comments and observations provided by Gregory Morvillo, Esq., a partner with Orrick, Herrington & Sutcliffe, many of which have been incorporated into this Article, and the significant editorial assistance provided by Carla Centanni, Roger Williams University School of Law Class of 2020, and member of the *Roger Williams University Law Review*. Any errors or omissions in this Article, however, are entirely to the account of Professor Spacone.

1. *See* Dirks v. SEC, 463 U.S. 646, 659 (1983).

2. 773 F.3d 438 (2d Cir. 2014), *abrogated by* Salman v. United States, 137 S. Ct. 420 (2016).

3. United States v. Martoma (*Martoma I*), 869 F.3d 58 (2d Cir. 2017), *amended by* 894 F.3d 64 (2d Cir. 2017); United States v. Martoma (*Martoma II*), 894 F.3d 64 (2d Cir. 2017).

4. *Martoma II*, 894 F.3d at 67–68; *Newman*, 773 F.3d at 444.

5. *See Martoma II*, 894 F.3d at 73–76 (applying *Dirks*, 463 U.S. 646); *Newman*, 773 F.3d at 452 (applying *Dirks*, 463 U.S. 646).

justice. Hopefully sufficient information has been provided to offer insight into how and why the court grappled with the issue without detracting too much from, or obscuring, the doctrinal analysis.

Central to the Second Circuit's tribulations is the fact that there are no clear statutory guidelines as to what constitutes insider trading nor specific statutory language concerning how far the government should go with its enforcement powers.[6] Congress has not spoken to these issues and the general language of section 10(b) of the Securities and Exchange Act of 1934 (Exchange Act) and its implementing regulation, SEC Rule 10b-5, do not provide a clear standard as to what activities constitute fraud or who the targets for such an inquiry should be.[7] As one commentator aptly put it, it is up to the courts to determine the boundaries of insider trading by "bootstrap[ping] an interpretation of the law of insider trading up from other general legal concepts, particularly fraud as it appears in many different legal contexts."[8] Inherently, this "allows" courts in the insider trading context to reach different results in cases involving essentially the same fact patterns, which occurred in the Second Circuit. Put another way, defining tippee insider trading brings to mind Justice Potter Stewart's famous quote concerning obscenity: "I shall not today attempt further to define [obscenity] . . . [b]ut I know it when I see it . . . ."[9] Ofcourse,

6. Kim Lane Scheppele, *"It's Just Not Right": The Ethics of Insider Trading*, 56 L. & CONTEMP. PROBS. 123, 126 (1993). Congress has never defined insider trading. However, in 2015, Senators Jack Reed (D) and Robert Menendez (D) introduced the "Stop Illegal Insider Trading Act." S. 702, 114th Cong. (2015). The bill appears to have been in response to the narrowing of the evidence necessary to prove tippee liability in *Newman*. For a discussion of *Newman*, see *infra* section I.C. and II.A. Under the bill, it was irrelevant whether a trader knew the source of the required fiduciary duty or whether the source derived any personal benefit from tipping insider information. *See* S. 702; *see generally Reed & Menendez Introduce Bill to Clearly Define and Ban Unlawful Insider Trading*, JACK REED: U.S. SENATOR FOR R.I. (Mar. 11, 2015), https://www.reed.senate.gov/news/releases/reed-and-menendez-introduce-bill-to-clearly-define-and-ban-unlawful-insider-trading [https://perma.cc/MY8G-D7N6]. The bill goes well beyond where the Second Circuit ended up in the *Martoma* cases. However, the bill did not gain any traction in Congress, and based on the *Martoma* cases, it is unlikely to pick up any steam. Further, the bill is poorly crafted and would create more problems for potential defendants than it ostensibly cures, but this is a subject for another time.

7. *See* Scheppele, *supra* note 6, at 124.

8. *Id.*

9. Jacobellis v. Ohio, 378 U.S. 184, 197 (1963) (Stewart, J., concurring).

the Supreme Court "defined" obscenity, albeit with a subjective standard, but like the Second Circuit's efforts to define tippee insider trading, struggled to get there.[10]

Second, this Article will discuss how the two Second Circuit panels approached the issue of tippee liability as a means of better understanding the outcomes and providing a basis for the implications for future tippee liability cases in the Circuit. The conclusion that this article reaches is hardly earth shattering: the *Newman* court and the dissents in the *Martoma* cases took a narrow view of the personal benefit rule in the gift-giving context.[11] On the other hand, the majority in the *Martoma* cases approached tippee insider trading liability broadly.[12] Put simply, the former approach led to a favorable rule for the securities industry; the latter a highly favorable rule for the government. In the final analysis, it is no more complicated than this. How the panels reached their ultimate conclusions lay at the heart of this Article.

This Article will not analyze which case was doctrinally correct. Frankly, the answer of who got it "right" is best left to others, and neither case is entirely satisfying from a doctrinal perspective. Moreover, this Article is not a brief in support of open borders on insider trading.

Also, this Article will not pass judgment on the government's position on tippee liability other than to state that its approach as reflected in these cases is consistent with its general view that federal securities law should be interpreted broadly to protect investors.

I. BACKGROUND

A. *Introduction to Insider Trading*

Insider trading involves the purchase or sale of a security for personal gain on the basis of awareness, while in possession of MNPI concerning the issuer of the security in breach of a duty of confidentiality and trust owed directly, indirectly, or derivatively to the issuer of the security (e.g., a corporation), the shareholders of

10. *See* Scheppele, *supra* note 6, at 123–24.
11. *See Martoma II*, 894 F.3d 64, 81–82 (2d Cir. 2017) (Pooler, J., dissenting); United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014), *abrogated by* Salman v. United States, 137 S. Ct. 420 (2016).
12. *See Martoma II*, 894 F.3d at 73–74.

the issuer, or any other person who is the source of the MNPI.[13] The personal gain may be either a profit or avoidance of a loss.[14] Holding a security while in possession of MNPI is not insider trading.[15] The heart of insider trading is the breach of a duty of confidentiality with respect to the MNPI. This area presents the most complex interpretive issues.[16]

Insider trading is unfair because the person in possession of the MNPI has a significant trading advantage over other persons who do not have the information.[17] As will be discussed more fully below, the mere possession of MNPI as a basis for trading does not necessarily constitute fraud.[18] Indeed, the central issue in *Newman* and the *Martoma* cases was where to draw the line between legal and illegal use of MNPI by recipients of the information in the context of the securities industry, which thrives on asymmetry of information.[19] Simply put, insider trading is illegal. However, not all sharing of, and trading on, MNPI by recipients of the information is insider trading.[20]

A person in possession of MNPI has a duty of confidentiality with respect to that information and has two options to avoid prosecution for insider trading: either do not trade on the information, or "make appropriate disclosures"—i.e., make it sufficiently public—ahead of time.[21] The critical question at the center of *Newman* and the *Martoma* cases was when does a person have a duty of confidentiality?

The Supreme Court has adopted three theories of insider trading to capture "insiders." The classical theory deals with "actual" insiders,[22] and the "misappropriation" theory deals with

---

13. See 17 C.F.R. § 240.10b5-1 (2000) for the SEC's definition of insider trading, which includes tipper-tippee liability.

14. *See generally id.*

15. 17 C.F.R. § 240.10b5-1(a). This section requires that insider trading law applies only when there has been a "purchase or sale" of security. *Id.*

16. *See id.*

17. *See* Dirks v. SEC, 463 U.S. 646, 673 (1983) (quoting *In re* Cady, Roberts & Co., Exchange Act Release No. 6668, 40 SEC Docket 907, 912 (Nov. 8, 1961).

18. *See* § 240.10b5-1(b).

19. *See Martoma II*, 894 F.3d 64, 68 (2d Cir. 2017); United States v. Newman, 773 F.3d 438, 450 (2d Cir. 2014), *abrogated by* Salman v. United States, 137 S. Ct. 420 (2016).

20. *See* § 240.10b5-1(b).

21. *Dirks*, 463 U.S. at 651.

22. Generally, when people discuss the classical view of insider trading,

"outsiders" who misappropriate MNPI and trade on it.[23] The law is reasonably stable in these areas.

The third theory of insider trading is tippee liability.[24] When a person (tippee) purchases or sells a security for personal gain while in possession of MNPI received directly or indirectly from an insider (tipper) in breach of a duty of confidentiality, the tippee may be liable for insider trading.[25] The tipper also may be guilty of insider trading irrespective of whether he or she trades on the MNPI, but this is of secondary importance here.[26] As discussed, drawing the lines for tippee insider trading can be challenging.

It is important to understand that the term "securities" is expansive and includes many types of securities.[27] As such, insider trading violations can involve any type of security. The cases discussed in this article involve trading in public company common equity shares, which dominate most insider trading cases.

Although insider trading is not limited to shares of public companies that trade on national exchanges, such as the New York Stock Exchange and NASDAQ, almost all the cases arise in this context. The SEC can easily access trading activity on national exchanges. Further, the SEC is charged with the oversight, administration, and enforcement of federal securities laws.[28] The SEC pays particular attention to "unusual" trading activity in proximity to material corporate events such as mergers or earnings announcements, each of which can move share price up or down. In other words, the SEC works backwards from circumstantial evidence.[29] The detection mechanisms available to the SEC and

---

they point to Chiarella v. United States, 445 U.S. 222 (1980) (setting forth the classical view parameters of insider trading).

23. *See* United States v. O'Hagan, 521 U.S. 642, 649–50 (1997) (establishing the misappropriation theory of insider trading); *see generally* United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (originally crafting the misappropriation theory of insider trading).

24. *See Dirks*, 463 U.S at 647.

25. *Id.* at 662.

26. *See Martoma II*, 894 F.3d at 75 (citations omitted).

27. *See, e.g.*, 15 U.S.C. § 77b(a)(1) (2012). This section of the United States Code codifies the Exchange Act, which set forth the definition of what constitutes a security. *See also* 15 U.S.C. § 78(c)(a)(10), the section of the Exchange Act which contains essentially the same "list" of securities.

28. *What We Do*, U.S. SEC. AND EXCHANGE COMMISSION (June 10, 2013), https://www.sec.gov/Article/whatwedo.html [https://perma.cc/RQ37-VSSJ].

29. JAMES D. COX ET AL., SECURITIES AND REGULATIONS: CASES AND MATERIALS 942 (7th ed. 2017).

market participants, such as national exchanges and broker-dealers, cannot catch all indicia of potential insider trading, but they are sufficiently robust to have a meaningful deterrence effect. Detection is an important enforcement tool because there is good evidence that sanctions alone do not deter insider trading.[30]

If the SEC's suspicions are aroused, it has broad authority under the Exchange Act to commence an investigation into insider trading, including issuing subpoenas and taking depositions.[31] For those who engage in suspected insider trading, phone records, emails and statements from persons lower on the "food chain" who are promised immunity often provide ample evidence to support prosecution. Targets of insider trading investigations often make their lives worse by lying to investigators or otherwise unlawfully interfering with an investigation, thereby facilitating an obstruction of justice charge tacked on to insider trading charges.

One would think that sophisticated investors who engage in insider trading would be aware of the SEC's detection prowess and ability to ferret out damning information, especially improvident emails, as well as the need to be honest when talking to investigators. This does not appear to be the case for many who engage in insider trading; or perhaps they simply suffer from the hubris of thinking that they are too smart to be caught or that when caught, they can outsmart the government.

Insider trading cases rarely catch the imagination of the public, other than to reinforce the widely held view that Wall Street is inherently venal. Recently, however, the indictment of New York Congressman Christopher Collins (and others) for violating federal insider trading laws piqued the public's interest.[32] Collins is the alleged tipper, and his son and father-in-law are the alleged tippees.[33] The government claims that the two defendant tippees sold stock in a biotechnology company while in possession of MNPI

30. *Id.* The authors discussed this point and offered references to an article to support the proposition. It is a maxim of behavioral science, however, that, for many, absent detection, the mere potential of sanctions is not efficacious from an enforcement perspective.

31. *See* 15 U.S.C. § 78u(a)(1).

32. *See* Alan Feuer & Shane Golmacher, *New York Congressman Chris Collins Is Charged With Insider Trading*, N.Y. TIMES (Aug. 8, 2018), https://www.nytimes.com/2018/08/08/nyregion/chris-collins-insider-trading.html [https://perma.cc/GMC5-TGPK].

33. *Id.*

concerning a failed drug trial.[34] Collins shared the information with his son, who then passed it on to his future father-in-law and others.[35] The two named tippees—and several others who were not named in the indictment—used the information to avoid over $700,000 in losses.[36] Collins was prohibited from selling his stock because he sat on the company's board, but this is scant consolation under the scheme liability theory of insider trading.[37] Whether the government will prevail remains to be seen, but the Collins indictment is a classic example of tipper-tippee liability.

B. *Introduction to* Newman *and the* Martoma *Cases*

Newman and the *Martoma* cases focused on determining the level of evidence necessary for a fact finder to infer that the tipper received a personal benefit as a requirement to establish the duty of confidentiality. *Newman* and the dissents in the *Martoma* cases advocated an objective evidentiary standard as a means to limit overbroad application of tippee insider trading law in the context of gift-giving to so-called "friends."[38] The majorities in the *Martoma* cases opted for a subjective standard, which reflected an expansive view of tippee liability law in this context.[39] Each tethered their opinions to the seminal case on tipper-tippee liability, *Dirks v. SEC*, but as discussed, reached widely divergent outcomes.[40] The contours of tippee insider trading law in the Second Circuit are important because a high volume of cases, including many of high profile prosecutions, are litigated in the courts of the Southern District of New York. As such, the Second Circuit has become a leading appeals court, if not the leader, for insider trading law, subject of course, to cases that make their way to the U.S. Supreme Court, which has occurred only once in the last almost twenty

34. *Id.*
35. *Id.*
36. *Id.* There were several other individuals who also used the information but were not named in the indictment. *Id.*
37. *Id.*
38. *Martoma II*, 894 F.3d 64, 80 (2d Cir. 2017) (Pooler, J., dissenting); *see also* United States v. Newman, 773 F.3d 438, 452 (2d Cir. 2014) (holding that an objective standard is needed to establish the personal benefit requirement), *abrogated by* Salman v. United States, 137 S. Ct. 420 (2016).
39. *See Martoma II*, 894 F.3d at 76.
40. *See generally* Dirks v. SEC, 463 U.S. 646 (1983).

years.[41]

Prior to *Newman*, the law of insider trading regarding tippee liability in the Second Circuit had been relatively stable and highly favorable to the government. The United States Attorney's Office had a long history of successful criminal prosecutions of insider trading cases in the Circuit. *Newman* upset the status quo, breaking a string of successful insider trading cases prosecuted by the United States Attorney.[42] *Martoma II* restored most, if not all, of what *Newman* took away from the government on the personal benefit rule.[43]

Trading on MNPI for personal benefit may be a violation of section 10(b) of the Exchange Act, and SEC Rule 10b-5.[44] In short, these anti-fraud provisions prohibit any fraud or deceptive practices in connection with the purchase or sale of a security.[45] The essence of insider trading is that it involves fraudulent conduct and thus constitutes a violation of these provisions. As discussed, violators face harsh civil penalties[46]—i.e. up to three times the profit or loss avoided—and criminal penalties, including incarceration for up to twenty years, not to mention the significant costs associated with defending against government proceedings.[47] They also face serious reputational risks, which can have a major impact on their businesses and future employment prospects.

Summing up to this point, there are no clear statutory guidelines for what constitutes insider trading. The underlying provisions that prohibit insider trading are general, yet violations of insider trading law can have harsh consequences including

41. Nate Raymond, *NY Insider Trading Ruling Tests Prosecutors beyond Wall Street*, REUTERS: BUS. NEWS (Jan. 26, 2015, 7:05 AM), https://www.reuters.com/article/us-usa-insidertrading-analysis/ny-insider-trading-ruling-tests-prosecutors-beyond-wall-street-idUSKBN0KZ17W20150126 [https://perma.cc/2F6Z-B44P].

42. Ronak V. Patel & Toby M. Galloway, *Tippee Insider Trading after Newman and Salman: Why Knowledge Is Not Always Your Friend*, WHITE COLLAR CRIME COMM. NEWSL. (ABA), Jan. 2017, at 3.

43. *See generally Martoma II*, 894 F.3d 64, 75 (2d Cir. 2017).

44. 15 U.S.C. § 78j (section 10(b) of the Exchange Act); 17 C.F.R. § 240.10b-5 (SEC Rule 10b-5).

45. 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5. Both of these speak in terms of the requisite fraud occurring in connection with the "purchase or sale of any security."

46. *See* 15 U.S.C. § 78u-1.

47. *See generally* 15 U.S.C. § 78ff.

criminal penalties. It is axiomatic that the broader insider trading law is, the more people will be subject to harsh civil and criminal penalties, not to mention heavy costs to defend themselves if they are named in a government proceeding. As will be discussed presently, the unfairness of insider trading is another important dimension that influences the development of insider trading law.

The SEC has the power to bring civil enforcement actions for insider trading violations under section 10(b)/rule 10b-5.[48] The SEC may initiate civil proceedings in an administrative law court, depending on the target, or in a United States federal district court.[49] Criminal prosecutions may be brought in federal district court only by the DOJ either independently or by referral from the SEC.[50] While private suits are permitted under section 20(a) of the Exchange Act they are uncommon for reasons beyond the scope of this Article.[51]

Ultimately, the contours of insider trading law reside with the courts. Most insider trading cases, at least the high-profile cases, involve criminal prosecutions. This is important because in calculating the limits of tippee liability law, one would hope that the courts are cognizant of the consequences arising from the limits they draw or do not draw.

The SEC, ostensibly, has considerable discretion under the "*Chevron* doctrine" to enact rules to implement section 10(b).[52] The SEC has defined insider trading in rule 10b-5-1.[53] The rule states

48. 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5.

49. *How Investigations Work*, U.S. SEC. AND EXCHANGE COMMISSION (Jan. 27, 2017), https://www.sec.gov/enforce/how-investigations-work.html [https://perma.cc/6LUN-66CJ].

50. *See* Securities Subcommittee of the White Collar Criminal Litig. Comm., *Criminal Prosecutorial Discretion in Insider Trading Cases: Let's Look at the Numbers*, N.Y. ST. B. ASS'N 1 (May 12, 2010), https://www.nysba.org/Sections/Commercial_Federal_Litigation/ComFed_Display_Tabs/Reports/CRIMINALPROSECUTORIALDISCRETIONINTHEINSIDERTRADINGCASES_pdf.html [https://perma.cc/U486-8P57].

51. *See* 15 U.S.C. § 78t-1.

52. Chevron, U.S.A., Inc. v. NRDC, Inc., 467 U.S. 837 (1984). In this landmark case, the Supreme Court sustained the Environmental Protection Agency's interpretation of a provision in the Clean Air Act holding in the process that the courts should defer to executive agency interpretation of the laws they administer provided the law is ambiguous and the interpretation reasonable. *Id.* The Court traced this power to Congress' authorization of agency rule making. *Id.*

53. 17 C.F.R. § 240.10b-5-1.

that the law of insider trading is "otherwise defined by judicial opinions," which is the SEC's way of saying that it has the power to define insider trading law as well.[54] Furthermore, under the *Chevron* doctrine, the SEC's position is that its interpretation of the law should be given deference by the courts.[55]

Importantly, the government is afforded wide discretion to bring insider trading enforcement proceedings and aggressively urges its view on the courts, even those views, which the court previously rejected. The courts do not always embrace the SEC's view of insider trading law, as *Dirks*, *Newman*, and other cases reveal.[56] As will be discussed below, *Dirks* and *Newman* sought to limit the reach of insider trading law because of the serious consequences for certain information sharing activity that merit protection from the reach of insider trading law.

The animus behind insider trading law is that the practice is fundamentally unfair to shareholders who do not have the information and thus miss the opportunity to make gains or trim losses through trading.[57] This represents an asymmetry of information between those who have the information and those who do not. Various plausible market efficiency and transparency arguments have been made against regulating insider trading, but, as far as the SEC is concerned, they are not strong enough to outweigh the fundamental unfairness of the conduct.[58]

The unfairness aspect of insider trading drives government enforcement actions under section 10(b)/rule 10b-5. Insider trading runs counter to the SEC's mandate to protect investors and ensure

---

54. *Id.*

55. *See Chevron*, 467 U.S. at 842–43.

56. *See generally* Dirks v. SEC, 463 U.S. 646 (1983); United States v. Newman, 773 F.3d. 438 (2d Cir. 2014), *abrogated by* Salman v. United States, 137 S. Ct. 420 (2016).

57. *See, e.g.*, *In re* Cady, Roberts & Co., Exchange Act Release No. 6668, 40 SEC Docket 907, 912 (1961). *Cady, Roberts* is the seminal case on the application of section 10(b) to market trading transactions. That decision was premised on the fundamental unfairness of insider trading and the need to regulate it under the anti-fraud statute. *See also* Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Release No. 8459, 43 SEC Docket 933, 936 (Nov. 25, 1968). Fraud in an insider trading case derives from "inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing." *Cady, Roberts*, 40 SEC Docket at 912.

58. *See* COX ET AL., *supra* note 29, at 906.

the integrity and fairness of markets where they trade.[59] Because the SEC believes that insider trading undermines investor confidence in the integrity and fairness of securities markets, detecting and prosecuting insider trading violations is one of the SEC's enforcement priorities.[60] To put it bluntly, the Agency hates insider trading and its track record in prosecuting such actions is formidable, although there has been at least one notable exception recently in addition to *Newman*.[61] Merely being the subject of an insider trading investigation can cost one dearly as the professional golfer Phil Mickelson recently found out.[62]

C. The Securities Industry

It is important to briefly discuss how the securities industry obtains and uses information concerning issuers because the industry was front and center in *Newman* and in the *Martoma* cases.[63] Indeed, the securities industry is especially susceptible to

---

59. *What We Do*, *supra* note 28.

60. *Insider Trading*, U.S. SEC. AND EXCHANGE COMMISSION, https://www.investor.gov/additional-resources/general-resources/glossary/insider-trading [https://perma.cc/3TWQ-G2BJ] (last visited Aug. 9, 2018).

61. *See, e.g.*, SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009). Yes, this is *the* Mark Cuban. He prevailed at trial on the duty issue. Purportedly, he said at a law school forum, "If you got resources, fight 'em," referring to the SEC, "because they're not that smart." Holman W. Jenkins, Jr., *What Elon Can Learn from Mark Cuban About Fighting the SEC*, WALL STREET JOURNAL: BUSINESS WORLD (Aug. 24, 2018, 6:31 PM), https://www.wsj.com/articles/what-elon-can-learn-from-mark-cuban-about-fighting-the-sec-1535149910 [https://perma.cc/D66Q-2PHU]. We do not have time for this here, but it is doubtful that Elon Musk is *in pari delicto* so to speak with Cuban but he certainly has the funds and insurance to fight the SEC if it decides to go after him for his infamous twit on Tesla going private.

62. Patel & Galloway, *supra* note 42, at 7–8. Michelson was named as a so-called "relief defendant" in a criminal complaint filed against the tipper of the MNPI and tippee. The tippee defendant passed on the confidential information to Mickelson who traded on it. Perhaps mindful of *Newman*'s knowledge requirement, the government decided not to criminally charge Mickelson as a remote tippee. He ended up, however, disgorging the approximately $930,000 profit he made from the trade plus interest. No doubt, he paid his lawyers a handsome fee as well. Perhaps, he should have sought Mark Cuban's counsel. Although, given what was at stake, Mickelson appears to have made the right decision.

63. *Martoma II*, 894 F.3d 64, 67–68 (2d Cir. 2017); *Martoma I*, 869 F.3d 58 (2d Cir. 2017), *amended by* 894 F.3d 64 (2d Cir. 2017); United States v. Newman, 773 F.3d 438 (2d Cir. 2014), *abrogated by* Salman v. United States,

insider trading violations. Market analysts, financial reporters, traders, and investment advisors hunger for important economic information to derive revenues or profits for their firms and on occasion, for themselves. As such, they relentlessly employ a variety of methods and tools not available to most of the general investing public to ascertain and analyze information that they can pass on to their investor clients for potential trading purposes. Often, securities professionals, especially market analysis, make provident trading decisions for their firms, as is the case with traders. Often market analysts will have direct communications with insiders, such as investor relations personnel, to further their information gathering, albeit ostensibly in compliance with the federal securities laws. Further, market analysts and traders often share information, especially when they work for the same brokerage firm.

At the risk of simplification, the foregoing discussion can be summarized as such: the securities industry thrives on important economic information concerning issuers, and the sooner it can get the information and the more reliable the information, the better. This is a powerful motivating force that can lead to insider trading.

There is nothing inherently illegal concerning market professionals' search for information, or the selective use of that information for their clients or firms. As the Supreme Court stated, "[i]t is the nature of this type of information, and indeed of the markets themselves, that such information cannot be simultaneously available to all of the corporation's stockholders or the public generally."[64] Again, it is not necessarily illegal for an investor or securities professional to obtain critical economic information concerning a corporation. Moreover, in such circumstances, an insider might disclose MNPI that ends up in an investor's hand inadvertently or without the intent that it be a "gift."[65]

The SEC acknowledges and encourages the flow of important economic information from market analysts to investors because it is important to the latter's investment decisions, and is thus

137 S. Ct. 420 (2016).

64. Dirks v. SEC, 463 U.S. 646, 659 (1983).

65. *See id*.

necessary to the preservation of a healthy market.[66] The analysis, for purposes of insider trading violations, gets complicated, as was the case in *Newman* and the *Martoma* cases, when MNPI enters the picture, especially for traders who extract profits or avoid losses for their firms based on the information.

Sorting out who is engaging in insider trading and who is not is a challenge because, depending on the governing rules, all or some of the involved persons may be caught in the government's enforcement net. Moreover, broad application of insider trading law, or at least the threat of it, can chill legitimate market communications. Equally important is that members of the securities industry need to order their professional lives around the rules that govern insider trading and face the consequences if they violate them. Understanding the rules is of paramount importance, or at least should be.

On the opposite side of the equation is the SEC. The SEC would agree that "certainty" surrounding insider trading law is a good thing, and it even encourages the free flow of information to the market. The SEC and many securities professionals diverge on whether insider trading law should be narrow or broad. Certainly, the two views are divergent, and the outcome is important to each stakeholder. Tellingly, in *Dirks*, the Supreme Court granted a writ of certiorari to address the issue of tippee liability because of its "importance to the SEC and to the securities industry."[67]

II. THE DUTY OF TRUST AND CONFIDENTIALITY (DUTY OF CONFIDENTIALITY) AND THE SECOND CIRCUIT'S "EXCEPTION"

The Supreme Court has long recognized that the heart of any insider trading case, including tippee insider trading, is a breach of the duty of confidentiality.[68] In other words, the duty arises from the fiduciary relationship between the insider and the corporation, its shareholders, and others.[69] This is an extrapolation of the common law of fiduciary duty. The breach of the duty of confidentiality is the fraudulent conduct that triggers a section

66. *See id.* at 658.
67. *Id.* at 652.
68. *See In re* Cady, Roberts & Co., Exchange Act Release No. 6668, 40 SEC Docket 907, 912 (Nov. 8, 1961); *see also* Chiarella v. United States, 445 U.S. 222, 227 (1996).
69. *See Cady, Roberts*, 40 SEC Docket at 911.

10(b)/rule 10b-5 violation.[70]

By requiring a duty of confidentiality as a prerequisite to an insider trading violation, the Supreme Court imposed a limitation on what constitutes insider trading.[71] Without this limit, section 10(b) and rule 10b-5 could be interpreted in the extreme resulting in a violation for any trading of MNPI. For example, if a passerby finds a confidential memorandum concerning a merger that fell out of a CEO's brief case, she is free to trade on it. She has no duty to the corporation; she has committed no fraud. If a thief breaks into an office building, steals the same information and trades on it, he breaches no duty to the corporation and is thus free to trade on the information, although he is certainly guilty of theft. Indeed, the Supreme Court has held that_there is no general duty between participants in market transactions to forego actions based on MNPI.[72]

Interestingly, in *SEC v. Dorozhko*, the Second Circuit sanctioned the application of insider trading law in the context of cybercrimes and computer hacking, in the absence of a duty of confidentiality that involved a "misrepresentation."[73] The hackers traded on an earnings report that they accessed from the issuer's computer system before the report was made public.[74] The district court rejected the defense's argument that the SEC needed to prove a breach of the duty of confidentially, stating that "[t]o eliminate the fiduciary duty requirement now would be to undo decades of Supreme Court precedent, and rewrite the law as it has been developed."[75] The Second Circuit accepted the argument on appeal and sent the case back to the trial court for further consideration based on its ruling.[76] In short, the court reasoned that if the

70. *See id.*

71. *Chiarella*, 445 U.S. at 232 ("[N]ot every instance of financial unfairness constitutes fraudulent activity under section 10(b) .... "); *see also* Dirks v. SEC, 463 U.S. 646, 653–54 (1983).

72. *Dirks*, 463 U.S. at 654.

73. SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009). For an excellent discussion of this interesting case, which I drew on for this Article, see Brittney Pagliarini, Inside-Out: The Erosion and Evolution of the Fiduciary Duty Principle in Insider Trading Cases (May 2017) (unpublished student paper, Roger Williams Univ.) (on file with the author).

74. *Dirks*, 463 U.S. at 654.

75. SEC v. Dorozhko, 606 F. Supp. 2d 321, 323 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 (2d Cir. 2009).

76. *Dorozhko*, 574 F.3d at 48.

defendant's conduct involved gaining access to the corporation's computer system through affirmative misrepresentation of one's identity, as opposed to discovering weaknesses in the computer software, that constituted a deceptive or fraudulent practice under section 10(b).[77] As such, the conduct was actionable as insider trading because the MNPI was the basis for the subsequent trading.[78] The court's decision is notable because it did not mention rule 10b-5, and instead analogized a violation of section 10(b) to common law fraud to support its holding.[79] Frankly, the case appears to be more of a misrepresentation case than an insider trading case, which makes it all the more more confusing.

One way to view *Dorozhko* is that it created a fourth judicial theory for insider trading—the "affirmative misappropriation theory."[80] However, the case was widely criticized,[81] and has not gained any traction outside the Circuit.[82] The most notable aspect of the decision for purposes of this Article is that while the court's reasoning is defensible on its own terms, the Second Circuit appears to have gone "out of its way" to accommodate the SEC's expansive view of insider trading, which decidedly was not the case in *Newman*, but certainly was in the *Martoma* cases.[83] In this broad sense, it appears that the *Martoma* cases are more consistent with the Second Circuit's general view of insider trading law than *Newman*.[84]

77. *Id.* at 49.

78. *See id.* at 51.

79. *Id.* at 46.

80. *See generally* Ryan Gilinson, *Clicks and Tricks: How Computer Hackers Avoid 10b-5 Liability*, 82 BROOK. L.REV. 1305, 1308–09 (2017).

81. *See, e.g.*, Stephen Bainbridge, *The Second Circuit's Egregious Decision in SEC v. Dorozhko*, PROFESSORBAINBRIDGE.COM (July 29, 2009), http://www.professorbainbridge.com/professorbainbridgecom/2009/07/the-second-circuits-recent-decision-in-sec-v-dorozhko-available-here-dealt-with-one-of-the-questions-left-open-by-the.html [https://perma.cc/6D9R-WWM4]. Professor Bainbridge faults the Second Circuit for "finessing" the insider trading rules by treating the case as one of misrepresentation rather than insider trading. *Id.* He has a point.

82. James A. Jones II, *Outsider Hacking and Insider Trading: The Expansion of Liability Absent a Fiduciary Duty*, 6 WASH. J. L. TECH. & ARTS 111, 119–21 (2010).

83. *See Martoma I*, 869 F.3d 58 (2d Cir. 2017), *amended by* 894 F.3d 64 (2d Cir. 2017); *see also* United States v. Newman, 773 F.3d. 438 (2d Cir. 2014), *abrogated by* Salman v. United States, 137 S. Ct. 420 (2016).

84. *See Martoma I*, 869 F.3d 58 (2d Cir. 2017), *amended by* 894 F.3d 64 (2d Cir. 2017); *see also Newman*, 773 F.3d 438 (2d Cir. 2014), *abrogated by* Salman

As discussed, insider trading analysis becomes more complicated when an insider tipper intentionally shares MNPI with another person, the tippee, who trades on it, or passes it on to another person who trades on it (remote tippee).[85] If an essential element of insider trading is a breach of confidentiality then, absent a duty, the tippee is free to trade on the information because he or she has no duty to the corporation or its shareholders. There is no fraud. Clearly, the tippee has an unfair advantage compared to investors who do not have the information. However, unfairness in and of itself is not fraud, irrespective of how egregious it might be. If unfairness were the touchstone of a section 10(b)/rule 10b-5 violation, then capital formation in the United States would be seriously impaired. Here is where *Dirks* enters the picture with its "exportation" of the insider's duty of confidentiality to the tippee.

III. DEFINING TIPPEE LIABILITY: *DIRKS*, TO *NEWMAN*, TO *SALMAN*

A. Dirks*: The Personal Benefit Rule Emerges*

The *Dirks* Court sought to address the duty gap in the context of tippee liability and provide clarity and guidance, especially in the context of security industry practices. In the process, the Court made it clear that trading on MNPI, without more, was not illegal, which was consistent with prior pronouncements.[86] Moreover, Justice Louis Powell, writing for the majority, sought to establish a rule that did not unduly infringe on legitimate practices in the securities industry.[87]

The defendant in *Dirks* was an officer of a brokerage firm that specialized in providing investment advice to institutional investors concerning insurance company securities.[88] A former officer of a public insurance company provided Dirks with information concerning fraudulent practices by the company.[89] The former insider urged Dirks to investigate the fraudulent conduct that led to massive misrepresentation of the company's assets and expose

v. United States, 137 S. Ct. 420 (2016).

85. Patel & Galloway, *supra* note 42, at 1–5.
86. Dirks v. SEC, 463 U.S. 646, 662 (1983).
87. *Id.* at 658.
88. *Id.* at 648.
89. *Id.* at 648–49.

the fraud publicly, which he did.[90] Neither the former insider nor Dirks traded on the information, but Dirks discussed it with a number of his clients and investors. Some of those clients and investors traded on the information, thus avoiding losses that ensued once the fraudulent information became public and the company's share price dropped precipitously.[91] The SEC's theory of the case was that once Dirks received the MNPI, he had an obligation not to disclose it to the investment community who later sold their stock, regardless of his motivation or occupation.[92] The SEC was arguing for a "parity of information" standard.[93] In other words, the focus should be on anyone who trades or tips, not the tipper.[94]

In a civil prosecution, Dirks was censured by the SEC after an administrative law court found him guilty of aiding and abetting illegal insider trading and in violation of section 10(b)/rule 10b-5.[95] The case eventually made its way to the United States Supreme Court.[96] In a six to three decision, the Court reversed the court of appeals, holding that the insider did not violate his duty to the corporation because he received no monetary or personal benefit from revealing the information, and the disclosure was not intended as a gift.[97] In the absence of a breach of duty by the insider, there was no "derivative" breach by Dirks.[98]

Central to the Court's reasoning was that the tippee assumes the insider's duty of confidentiality by participating in the breach; in other words, by participating in the fraudulent scheme. For the tippee, the duty is derivative of the insider's duty. Hence, the fraud is necessary to trigger section 10(b)/rule 10b-5-1. In a footnote, the

90. *Id.* at 649.
91. *Id.*
92. *Id.* at 651.
93. Jon Eisenberg, *How United States v. Newman Changes the Law*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG.: BLOGROLL (May 3, 2015), https://corpgov.law.harvard.edu/2015/05/03/how-united-states-v-newman-changes-the-law/ [https://perma.cc/QLR9-6BFE]. Eisenberg's discussion of *Dirks* and *Newman* is very insightful and was relied on heavily for this Article in this regard.
94. *Id.*
95. Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982), *cert. granted*, 459 U.S. 1014 (Nov. 15, 1982) (No. 82-276).
96. *Id.*
97. Dirks v. SEC, 463 U.S. 646, 646 (1983).
98. *Id.* at 667.

majority acknowledged the important role that Dirks played in bringing important information to investors that they otherwise might not have received.[99] Dirks' efforts where analogized to the role market analysts play in communicating important information to the market. In the eyes of Justice Powell, Dirks was merely doing what any good analyst would do.[100] Hence, the need to confine tippee liability law to protect market analysts and other securities professionals who are involved in the exchange of information from judicial over reach.

The Court established a two-prong requirement for which a jury could infer an insider trading violation when tippers and tippees were involved.[101] The tipper must have derived a direct or indirect personal benefit from the divulged information and, the Court explained, in dicta, the tippee must have had knowledge of the personal benefit associated with the exchange of the information.[102] The *Newman* court would run with both of these requirements.

It is the personal benefit rule in the gift-giving context among friends that stands at the center of *Newman* and the *Martoma* cases. In *Dirks*, the central focus was on the benefit received by the insider tipper, not whether the tippee received a benefit. This is a critical distinction because *Newman* fully embraced this principle whereas the courts in the *Martoma* cases focused on the benefit to the tippee, which entails a lesser evidentiary standard.[103]

In *Dirks*, the Court expressly identified personal benefits to include a relationship that suggests a quid pro quo arrangement, financial or otherwise, between the tipper and tippee, or a gift of MNPI to a trading relative or friend, where the tip and trade resemble trading by the insider himself followed by a gift of proceeds to the recipient.[104] Interestingly, the Court did not discuss how clear the relationship needed to be, although arguably the tenor of the decision pointed in this direction.

99. *Id*. at 652 n.8.
100. *Id*. at 658–59.
101. *Id*. at 665.
102. *Id*. at 662.
103. *Martoma II*, 894 F.3d 64, 68 (2d Cir. 2017); United States v. Newman, 773 F.3d 438, 442 (2d Cir. 2014), *abrogated by* Salman v. United States, 137 S. Ct. 420 (2016).
104. *Dirks*, 463 U.S. at 664.

By providing the government with alternative bases to prosecute tippee liability cases, *Dirks* hardly foreclosed government prosecutions. For example, proving a quid pro quo arrangement, which is arguably the most visible and pernicious form of insider trading, is relatively straightforward: Did the tipper receive money from the tippee in exchange for the MNPI? However, proving personal benefit in the gift-giving context is more difficult because it involves ambiguous fact patterns.

In introducing the personal benefit rule in *Dirks*, the Court sought a "guiding principle" for those market participants whose daily activities were limited and instructed by the SEC's insider trading rules.[105] The Court characterized the rule adopted by the SEC as having "no limiting principle."[106] The Court went on to note that the question of whether an insider personally benefited from disclosure would be based on "objective criteria," rather than reading the parties' minds to justify an inference that the insider received a personal benefit.[107] The court in *Newman* interpreted this to require evidence of a "meaningfully close personal relationship."[108]

In short, the *Dirks* Court erected a limiting principle in an attempt to mitigate against the inherent ambiguity and subjectivity surrounding the determination of what constitutes a personal benefit, not to mention other elements associated with proving illegal insider trading.[109] This "limiting principle" of *Dirks* figures prominently in *Newman* and *Martoma II*, although the Second Circuit had opposing views on the matter.

The Court's concern that insider trading law could sweep too broadly to ensnare or deter market professionals who were performing an important market function is understandable. In this sense, *Dirks* was all about "policing insiders and what they do . . . rather than policing information *per se* and its possession . . . ."[110] At the same time, the Court recognized that there was a clear need for a ban on some tippee trading.[111] In effect, by establishing

105. *Id.*
106. *Id.*
107. *Id.* at 663.
108. United States v. Newman, 773 F.3d 438, 449 (2d Cir. 2014), *abrogated by* Salman v. United States, 137 S. Ct. 420 (2016).
109. Eisenberg, *supra* note 93.
110. *Id.*
111. *Dirks*, 473 U.S. at 659.

the personal benefit rule, the Court sought to thread the needle by better defining tippee liability, while containing it at the same time.

B. Newman*'s Gloss on the Personal Benefit Rule*

For many years *Dirks* was considered settled law. Starting in 2008, the SEC and the DOJ stepped up prosecutions of insider trading cases.[112] As discussed previously, the United States Attorney for the Southern District of New York had a string of eighty successful convictions.[113] Simultaneously, the government was aggressively investigating several hedge funds suspected of insider trading, with increased focus on remote tippees; that is, tippees that were one or more levels removed from the original tipper-tippee.[114] Then came *Newman*, and the personal benefit landscape changed dramatically.

Newman involved the criminal conviction of two portfolio managers, Newman and Chiasson, who traded on inside information passed on by market professionals who received the information from two corporate insiders.[115] The prosecution was complicated because the defendants were "remote" tippees.[116] The players in this saga were characterized by the court as "acquaintances."[117] There was no evidence of any pecuniary or similar gain associated with the original exchange of the information by the corporate insiders, or that the defendants knew who originally shared the information, let alone whether it was for a personal benefit.[118]

The government argued that it was required to prove that the defendants traded on MNPI that they knew insiders disclosed in a breach of a duty of confidentiality.[119] This is how the government read *Dirks*. The jury instructions essentially mirrored the government's position and the defendants were convicted on this basis.[120]

---

112. Patel & Galloway, *supra* note 42, at 3.
113. Id.
114. Id.
115. Raymond, *supra* note 41.
116. United States v. Newman, 773 F.3d 438, 442 (2d Cir. 2014), *abrogated by* Salman v. United States, 137 S. Ct. 420 (2016).
117. *Id.* at 448.
118. *Id.* at 453.
119. *Id.* at 453.
120. *Id.* at 445–46.

On appeal, the *Newman* court reversed the convictions.[121] Relying heavily on its understanding of *Dirks*' limiting principle, it found the jury instructions wanting and held that, under the personal benefit rule, for a factfinder to infer a benefit in the context of gift-giving, there must be 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."[122] The court held that there was insufficient evidence in this regard, and reversed the convictions on this basis as well as another, which is discussed below.[123]

In short, the court concluded that the government could not satisfy the personal benefit requirement of *Dirks* by producing evidence of a mere "casual or social nature."[124] The court also rejected the idea that mere gift-giving would be sufficient for a jury to infer a personal benefit.[125] It is important to understand that central to the court's holding was that, in its mind, the government was advancing a novel view of insider trading law that sought to reach remote tippees, which the court considered contrary to *Dirks*.[126] In this regard, the court noted that in prior cases, tippees that were as remote as Newman and Chiasson had never been criminally liable for insider trading.[127]

Interestingly, the gloss *Newman* put on the *Dirks* personal benefit rule was not the main holding of the case.[128] Specifically, *Dirks*' knowledge of the personal benefit requirement was the main focus of the appellants' argument.[129] A reading of the portion of the opinion that addresses this issue hardly presages where the court finally came out. Somewhat of an exaggeration, but the pecuniary relationship or similar nature requirement appeared largely out of nowhere. It certainly was not mentioned in *Dirks*.

In any event, the court also reversed echoing *Dirks* on the

121. *Id.* at 444.
122. *Id.* at 452.
123. *Id.*
124. *Id.*
125. *See id.*
126. *Id.* at 448.
127. *Id.*
128. *Id.* at 452.
129. Telephone Interview with Gregory Morvillo, Partner, Orrick, Herrington & Sutcliffe (Sept. 5, 2018) [hereinafter Morvillo Interview].

ground that there was insufficient evidence that the defendants knew that the original tippers received a personal benefit.[130] The appellants argued that the jury must find that they knew that the MNPI had been *disclosed for a personal benefit*.[131] The court, expanding on the dicta in *Dirks*, agreed with the appellants and spent a considerable amount of time discussing the issue.[132] The subsequent case law discussed in this Article leaves this leg of *Newman* untouched, and thus there is no virtue in further delving into the court's thinking there, other than to point out that the *Dirks* knowledge requirement, which was elaborated on in *Newman*, remains very much alive in the Second Circuit—at least for now.

Newman was controversial for at least two reasons. The phrase "meaningfully close personal relationship" does not appear in *Dirks*, and according to the majority in *Martoma II*, the phrase was "new to our insider trading jurisprudence."[133] In fairness to the *Newman* court, *Dirks* arguably allowed for such an extrapolation by requiring "objective" evidence to support the personal benefit inquiry. The *Newman* court merely defined more concretely what the government needed to prove to establish the friend relationship.

More problematic from a doctrinal perspective, the *Newman* court went well beyond *Dirks* by requiring the government to prove that the tipper received something of a pecuniary or similarly valuable nature from the exchange of information.[134] A fair reading of *Dirks* is that a gift may include something of monetary or similar nature, but this is not the only indicia of what constitutes a gift—let alone what constitutes a personal benefit. As discussed, *Dirks* provided the government with alternatives to prove personal benefit.[135] In the gift-giving context, *Newman* took away one of those options by imposing the pecuniary or of similar nature requirement.[136] More importantly, *Newman* was susceptible to being viewed as an inflexible rule that created the potential of

130. *Newman*, 773 F.3d at 442.
131. *Id*. at 444.
132. *Id*. at 444, 447–50, 454.
133. *Martoma II*, 894 F.3d 64, 77 (2d Cir. 2017).
134. *Newman*, 773 F.3d at 452.
135. *Id*. at 444.
136. *Id*. at 452–53.

letting "garden variety" tippee insider trading slip through the enforcement net.[137] This would be on the majority's mind very much in the *Martoma* cases.

Why the court felt compelled to go beyond the language of *Dirks* on the personal benefit rule is a fair question. Intellectual underpinnings aside, the decision was jarring especially because of the Second Circuit's long history of accepting the government's view of insider trading. *Dorozhko* certainly underscores this point.[138] In that case, the high standard of proof necessary to sustain a criminal conviction—not to mention the severe consequences of a conviction—were clearly on the court's mind. In this regard, two commentators noted, "it is more likely the *Newman* court was influenced by its view that the government's efforts to prosecute remote tippees was a 'doctrinal novelty,'" and as a result construed the friends-relative inference narrowly.[139] In a similar vein, as one admirer of *Newman* has put it, the court sought to establish "brighter lines to cabin prosecutorial and SEC discretion in bringing future criminal and civil insider trading actions."[140] The same can probably be said for the strengthening of *Dirks*' knowledge requirement. Simply put, the court concluded that the government went too far with its view of tippee liability.

The *Newman* court's opinion reveals its sensibility to the impact of tippee liability on the securities industry. The opinion's gloss over the personal benefit rule acknowledges, at least implicitly, that the mere filing of an insider trading case puts defendants at great financial risk, irrespective of the outcome once the law is applied. Moreover, the specter of enforcement actions can have a chilling effect on the flow of important information concerning issuers that is critical to the securities market and the lifeblood of the securities industry.[141]

In sum, *Newman* created a narrow two-part requirement for establishing personal benefit in the context of gift-giving between friends, which made the government's evidentiary burden much greater, even in cases that did not involve remote tippees.[142] The

137. *See Martoma II*, 894 F.3d at 77; Patel & Galloway, *supra* note 42, at 5.
138. SEC v. Dorozhko, 574 F.3d 42, 50 (2d Cir. 2009).
139. Patel & Galloway, *supra* note 42, at 5.
140. Eisenberg, *supra* note 93.
141. *See Newman*, 773 F.3d at 449.
142. Patel & Galloway, *supra* note 42, at 4.

Martoma cases would prove to be just such a case. Going back to the critical stakeholder analysis, the securities industry received a narrow legal rule in the area of tippee liability.

Not surprisingly, the government did not receive the decision favorably,[143] and as the *Martoma* cases revealed, it was unpopular within the Second Circuit.[144] The SEC characterized the decision as greatly limiting its ability to prosecute "the most common, culpable, and market-threatening forms of insider trading."[145] Perhaps something of an exaggeration, but the United States Attorney for the Southern District of New York dropped seven insider trading charges because of *Newman* and threatened to move prosecutions outside the Second Circuit.[146]

The government's petition for its rehearing and, eventually, its writ of certiorari, were denied.[147] The writ was most likely denied because there was no clear circuit split on the requirements for establishing a personal benefit. This would soon change, however.

C. Salman*: *Newman*'s Pecuniary or Similar Value Requirement Eliminated*

In *United States v. Salman*, the Ninth Circuit was faced with an appeal of a tippee insider trading conviction based on *Newman*'s "meaningfully close personal relationship" gloss on the personal benefit rule.[148]

Salman traded while he was in possession of MNPI that he

143. *See, e.g.*, Silvia Stockman, *United States v. Newman: The Second Circuit Establishes New Limits on Insider Trading Prosecutions*, 34 REV. BANKING & FIN. L. 427, 432–33 (2015); *but see* Eisenberg, *supra* note 93. Doctrinal analysis aside, the difference in views concerning *Newman* ultimately comes down to whether one thinks the inquiry into tippee liability should be broad or narrow. See Stockman, *supra*, at 433, for a discussion of how *Newman* was applied in and outside the Second Circuit. I can say, from personal experience, it was not followed by the United States District Court for the District of Rhode Island. *See also* SEC v. Andrade, 157 F. Supp. 3d 124, 127–28 (D. R.I. 2016).

144. *See generally Martoma II*, 894 F.3d 64 (2d Cir. 2017).

145. Eisenberg, *supra* note 93.

146. *See* Patel & Galloway, *supra* note 42, at 9 n.xxxv.

147. United States v. Newman, 773 F.3d. 438 (2d Cir. 2014), *reh'g en banc denied*, 2015 WL 1954058 (2d Cir. Apr. 3, 2015), *and cert. denied*, 136 S. Ct. 242 (2015).

148. United States v. Salman, 792 F.3d 1087, 1093 (9th Cir. 2015).

obtained from an investment banker.[149] The tipper investment banker shared the information with his brother-in-law who not only traded on it, but also shared it with his friend, Salman, who also happened to be the tipper's brother-in-law.[150] Unlike in *Newman*, the evidence produced at trial revealed that the tipper and tippee had a "very close" friend-relative relationship.[151] As such, Salman had a weak defense under *Dirks*. The MNPI was a gift to a trading relative who clearly knew that the tipper received a personal benefit from the exchange of MNPI.[152] For this reason (and others), Salman was convicted.[153]

Newman was decided while Salman's appeal from his conviction was pending before the Ninth Circuit, and he relied on that case to provide a basis for reversal. He essentially argued that the tipper did not receive a pecuniary gain or something of similar value from the exchange of the MNPI; hence there was no personal benefit.[154] In other words, merely giving of gift of MNPI to a trading relative or friend was not enough to support an inference of personal benefit.

Interestingly, Judge Jed Saul Rakoff, a Senior United States District Court Judge for the Southern District of New York, was sitting by designation on the Ninth Circuit. He was assigned the opinion in *Salman*. Judge Rakoff, writing for a unanimous court, concluded that *Dirks* allowed the jury to infer that the tipper breached a duty because he made "a gift of [MNPI] to a trading relative."[155] To the extent that *Newman* went further and required additional gain to the tipper in cases involving gifts of MNPI to family and friends, the Ninth Circuit "decline[d] to follow it."[156] Central to the court's holding was its concern that a loophole would be created if tips were lawful simply because the tipper did not ask for "tangible compensation in return."[157]

The Supreme Court was now faced with a clear conflict between two important Circuits, which paved the way for *Salman*

149. *Id.* at 1089.
150. *Id.* at 1089, 1094.
151. *Id.* at 1090.
152. *Id.* at 1092.
153. *Id.* at 1094.
154. *Id.* at 1093.
155. *Id.* at 1092.
156. *Id.* at 1093.
157. *Id.* at 1094.

to make it to the Court. As previously mentioned, the Supreme Court had not taken up an insider trading case in almost twenty years.[158] In a narrow decision, the Court, relying heavily on *Dirks*, unanimously affirmed the Ninth Circuit's decision.[159] Tellingly, the Court concluded that the case was "easily" decided by *Dirks*.[160]

The Court reasoned that giving a gift of trading information is the same as the tipper trading and then gifting the proceeds.[161] However, the Court rejected the SEC's expansive view that a gift of MNPI to anyone, not just a trading relative or friend, is enough to prove securities fraud.[162] This is important because it reveals the Court's reluctance to take an expansive view of insider trading simply because it is unfair, which the Court made explicit.[163] Similarly, the Court did not seem impressed with the government's argument that "Salman's concerns about unlimited and indeterminate liability for remote tippees [was] significantly alleviated by other statutory elements that prosecutors must satisfy to convict a tippee for insider trading."[164] The majority in *Martoma II*, however, would be more receptive to the government's argument.[165]

The *Salman* opinion reflects a recognition that limits need to be placed on insider trading law as it applies to tippees lest it sweep too broadly by not providing reasonably clear guidelines. To this point, the Court stated that *Dirks* provided a "simple and clear 'guiding principle'" for determining tippee liability in the context of gift-giving to close friends and relatives that was neither uncertain nor indeterminate.[166] As such, the Court was wholly consistent with the underlying limiting principle in *Dirks*. In this regard, the *Salman* Court concluded that under the facts of the case at bar, that

158. Ben Protess & Matthew Goldstein, *What is a 'Personal Benefit" from Insider Trading? Justices Hear Arguments*, N.Y. TIMES (Oct. 5, 2016), https://www.nytimes.com/2016/10/06/business/dealbook/supreme-court-insider-trading.html [https://perma.cc/R2TE-EG8R].

159. Salman v. United States, 137 S. Ct. 420, 427 (2016).

160. *Id.*

161. *Id.* at 427–28.

162. *Id.* at 427.

163. *Id.*

164. *Id.*

165. *See infra* section III.A and III.B.

166. *Salman*, 137 S. Ct. at 428.

principle was not weakened.[167] Stated another way, the securities industry had clear guidelines for at least this aspect of insider trading. The Court rejected only one of the requirements for establishing personal benefit under *Newman*: the "pecuniary or of similarly valuable nature" requirement.[168]

Although the Court rejected part of *Newman*, it left intact the need for a "meaningfully close personal relationship" to form the basis for an objective inquiry as to what constitutes personal benefit.[169] The Court did not address the issue because it was not argued and, in any event, under any definition of the term, the tipper-tippee relationship before the Court was a close one, and it was discussed at some length.[170] Also, the Court did not disturb *Newman*'s gloss on the knowledge requirement, as it was not before the Court.

D. United States v. Martoma*: The Second Circuit's Attempts to Clarify the Personal Benefit Rule*

1. Martoma I[171]

The *Salman* Court did not intend to answer every question on tippee liability, but it did provide clarity concerning one aspect of the personal benefit rule. Truth be known, the pecuniary or similar value requirement of *Newman* was not supported by the language of *Dirks*, and its demise was not surprising. In *Martoma I*, the Second Circuit concluded that further clarification of the personal benefit rule was necessary.[172] In the process, the court drastically altered what was left of *Newman* relative to the personal benefit rule.

To remain chronologically organized, *Newman* came down after Martoma's conviction and *Salman* was decided shortly after the *Martoma I* court heard oral argument on Martoma's appeal.[173] While none of this was intentional, it certainly complicated matters.

In *Martoma I*, Martoma was a senior trader and portfolio

167. *Id.*
168. *Id.*
169. *Id.* at 425, 427.
170. *Id.* at 424.
171. *Martoma I*, 869 F.3d 58, 58 (2d Cir. 2017), *amended by* 894 F.3d 64 (2d Cir. 2017).
172. *Id.*
173. *Id.* at 58, 61; *Salman*, 137 S. Ct. at 420.

manager for a major hedge fund, S.A.C. Capital Advisors (SAC), which—along with its owner and manager, the infamous and highly successful, Steven Cohen—had been under investigation for insider trading.[174] In 2016, the government "blinked" at filing a criminal proceeding against Cohen for insider trading, but settled for a major civil fine and certain industry restrictions.[175] This background provides insight into the importance of the case for the court and for the government's unflagging determination to convict Martoma and other remote tippees who were members of the securities industry. While the case meant little to the public at large, it was a big deal for Wall Street.[176]

Martoma's conviction stemmed from an insider trading scheme involving securities of two pharmaceutical companies.[177] In short, he cultivated a relationship with two prominent doctors who were involved with a clinical trial for an Alzheimer drug that was developed jointly by two companies.[178] The doctors passed on publicly unavailable information to Martoma about the unfavorable results of the drug's testing.[179] One of the doctors passed on the critical information at two separate meetings.[180] Armed with this

174. *Martoma I*, 869 F.3d at 61.

175. Reuters, *Billionaire Steve Cohen's Hedge Fund to Pay $135M to Settle This Class Action Suit*, FORTUNE (Dec. 1, 2016), http://fortune.com/2016/12/01/billionaire-steve-cohen-hedge-fund-135-million-settlement-class-action-lawsuit/ [https://perma.cc/L7XA-KDVK].

176. *See* Walter Pavlo, *Prosecuting Insider Trading Cases Just Got Easier: The* Martoma *Decision*, FORBES (Sept. 6, 2017, 7:04 AM), https://www.forbes.com/sites/walterpavlo/2017/09/06/prosecuting-insider-trading-cases-just-got-easier-the-martoma-decision/#4822780b1bf0 [https://perma.cc/HE39-V4FW].

177. *Martoma I*, 869 F.3d at 61. This was not Matthew Martoma's first foray into illicit activity. In 1999, he was expelled from Harvard Law School for creating false transcripts while applying for clerkships with federal judges. *See* Matthew Goldstein & Alexandra Stevenson, *Ex-SAC Trader Was Expelled from Harvard Law School*, N.Y. TIMES (Jan. 9, 2014, 1:06 PM), https://dealbook.nytimes.com/2014/01/09/ex-sac-trader-was-expelled-from-harvard-law-school/ [https://perma.cc/TR4A-FFVU]. Years later, Martoma was also stripped of his MBA from Stanford University after the school discovered that he was admitted under false pretenses. *See* Steven Perlberg, *Former SAC Trader Mathew Martoma Just Lost His Stanford MBA*, BUS. INSIDER (Mar. 5, 2014, 2:11 PM), https://www.businessinsider.com/mathew-martoma-loses-stanford-mba-2014-3 [https://perma.cc/4BZN-CJC3].

178. *Martoma I*, 869 F.3d at 61.

179. *Id.* at 62.

180. *Id.*

information, the hedge fund reduced its positions in the two companies, and entered into short sales and other measures that would be highly profitable when the companies' share prices fell. Not surprisingly, the companies' share prices fell when the results of the drug trial were announced.[181] SAC obtained approximately $283 million in avoided losses and profits.[182] Martoma received a $9 million bonus in large part for his efforts.[183] Because *Newman* had yet to be decided, the jury instructions took an expansive view of what the government needed to prove to establish personal benefit, and they did not mention the "meaningfully close personal relationship" requirement.[184]

Martoma challenged the sufficiency of the jury instructions and the evidence. In short, he argued that his conviction should be reversed under *Newman* because *Salman* did not overrule *Newman*'s requirement that a tipper have a "meaningfully close personal relationship" with a tippee to support the inference that the tipper received a personal benefit from his gift of inside information.[185] In support of his contention, Martoma argued that he had a casual relationship with the doctor who provided him with the information.[186] He also argued that the doctor was not paid for the meetings that produced the critical information.[187] Martoma did not advance the tangible value requirement of *Newman* because *Salman* stripped it away.[188] Martoma also did not press the knowledge requirement of *Newman*, which would have been a weak argument anyway given that he was not a remote tippee.[189]

It is important to stop to reflect on what the court faced from an ad hominem perspective. While tippee insider trading may be difficult to define, Martoma's conduct certainly looked like insider trading by any common sense understanding of the term, and his conduct was certainly manifestly unfair to other investors who did not have the information.[190] Moreover, it is clear that the court was

181. *Id.*
182. *Id.* at 62–63.
183. *Id.* at 63.
184. *Id.* at 64–65.
185. *Id.* at 65.
186. *Id.* at 64–65.
187. *Id.*
188. *Id.* at 65, 68 n.6.
189. *See id.* at 78 n.11.
190. *See id.* at 62–63.

aware of Cohen's role.[191] However, *Newman*'s "meaningfully close personal relationship" requirement stood in the way of Martoma's conviction absent evidence of a quid pro quo arrangement.[192] Equally important, what was left of *Newman* imperiled the conviction of "future Martomas."[193] All of this could not have been lost on the court at some level, and it was certainly not lost on the government.

Thus, the court was faced with a damning set of facts and had no statutory guidance as to what constituted tippee insider trading—other than the requirement that the trading on the MNPI must involve fraud.[194] *Dirks* was controlling Supreme Court case law that the court could hardly overrule.[195] Still, *Dirks* left sufficient room for the court to determine "the appropriate way to determine when there is a personal benefit in the absence of a financial benefit."[196]

Newman presented a more difficult problem because it was recent Second Circuit precedent, and it appeared to leave less room for interpretation than *Dirks*. Between both the original and amended decisions, the court crafted a rule that basically nullified *Newman*'s relationship requirement. In short, the majority in *Martoma I* took a broad approach to the personal benefit rule, whereas the dissent adhered to the narrow approach in *Newman*.[197]

None of the judges who were on the panels in the *Martoma* cases participated in *Newman*, which probably has more to do with timing than anything else. Two members of the panel, however, clearly were not enamored with *Newman*.[198] The court affirmed

---

191. *See id.*
192. *See id.* at 68.
193. *See* Pavlo, *supra* note 176.
194. *See* Brad S. Karp, et. al., *Divided Second Circuit Panel Overrules Prior* Newman *Insider Trading Decision*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Sept. 7, 2017), https://corpgov.law.harvard.edu/2017/09/07/divided-second-circuit-panel-overrules-prior-newman-insider-trading-decision/ [https://perma.cc/CAE2-VUHM].
195. *See id.*
196. *See id.*
197. *See Martoma I*, 869 F.3d at 73.
198. *See* Harry Sandick & Kathryn Austin, *Newman's 'Meaningfully Close Personal Relationship' Requirement No Longer Good Law*, BLOOMBERG L. WHITE COLLAR CRIME REP. (Sept. 29, 2017), https://www.pbwt.com/content/uploads/2017/10/BNA_Newman%E2%80%99s-

the convictions over Judge Rosemary S. Pooler's spirited forty-four-page dissent.[199] In the process, the court did two things. First, it concluded that based on the "ongoing relationship" between Martoma and the tipper who provided the critical information, the jury could infer the essential elements of tippee insider trading, including a sufficient personal benefit for the tipper, under a "pecuniary quid pro quo theory" of *Dirks*.[200]

Second, and more controversially, the majority acknowledged that *Salman* did not explicitly reject the "meaningfully close personal relationship requirement," and concluded that *Salman* provided a basis for abrogating *Newman*'s relationship test.[201] Specifically, the majority concluded that "the straightforward logic of the gift-giving analysis in *Dirks*, strongly reaffirmed in *Salman*, is that a corporate insider personally benefits whenever he 'disclos[es] inside information as a gift . . . with the expectation that [the recipient] would trade' on the basis of such information ."[202] In the majority's mind, that was the case "because such a disclosure is the functional equivalent of [the tipper] trading on the information himself and giving a cash gift to the recipient."[203] Put differently, the court stated that giving MNPI to a tippee, with the expectation that he or she will trade on it, is presumed to be a gift for purposes of the personal benefit rule.[204] Critical to the majority's holding was that it applied only to an insider who shares MNPI with someone who "*he expects will trade on the information*."[205] In other words, the majority was not crafting a rule that deemed gift-giving in every context to be a personal benefit.

Before going further, it is important to reflect briefly on the implication of the holding. The *Martoma I* court replaced *Newman*'s narrow rule with a broader rule that swept within its ambit not only Martoma's conduct, but also that of Chiasson and Newman, as well as lesser forms of trading on MNPI, the latter of

%E2%80%98Meaningfully-Close-Personal-Relationship-Requirement-No-Longer-Good-Law_September-29-2017.pdf [https://perma.cc/AXT8-5APC].

199. *See id.*

200. *Martoma I*, 869 F.3d at 67.

201. *Id.* at 69.

202. *Id.* (alterations in original).

203. *See id.*

204. *Id.* at 71.

205. *Id.*

which arguably would not be captured under *Dirks*. As such, in a very subtle way, the majority may have been signaling that *Dirks* was no longer relevant.[206] The impetus for this may very well be that the current practices of the securities industry had "out grown" what the Supreme Court faced in *Dirks*.[207] In other words, technological advances made the exchange of MNPI between insiders and market analysts more sophisticated.[208]

The court's holding in *Martoma I* shifted the focus for personal benefit from the relationship between the tipper and tippee to the tipper's intent.[209] The majority "closed the deal" by concluding that *Newman*'s "meaningfully close personal relationship" requirement was no longer good law.[210] And, according to the majority, this was all accomplished in accordance with *Dirks*. In the process, the court stripped away an important layer of the government's evidentiary burden, and instead replaced it with a broad and subjective inquiry that greatly reduced the government's evidentiary burden.

In the eyes of Judge Pooler, the "majority's opinion exactly mirrors the government's view pressed in *Salman*: that 'a gift of confidential information to anyone, not just a "trading relative or friend," is enough to prove securities fraud.'"[211] She went on to state, "[i]n 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."[212]

Judge Pooler disagreed with the majority for other important reasons, but it is fair to trace her ultimate position to her view of *Dirks*' limiting principle, which was not shared by the majority.[213] One commentator accurately summarized the thrust of Judge Pooler's argument by noting that in the context of the majority's holding, "the risk of sweeping in 'innocent' conduct is far greater, and the corresponding need for clear boundaries more acute ."[214] Judge Pooler was willing to make a trade-off that the majority was

206. Morvillo Interview, *supra* note 129.
207. *Id.*
208. *Id.*
209. *See Martoma I*, 869 F.3d at 69; Sandick & Austin, *supra* note 198.
210. *Martoma I*, 869 F.3d at 69.
211. *Id.* at 86–87 (Pooler, J., dissenting) (quoting Salman v. United States, 137 S. Ct. 420, 426 (2016)).
212. *Id.* at 75.
213. *Id.* at 86–87.
214. Karp et al., *supra* note 194.

unwilling to make. In this regard, she implicitly referred to the very market professionals that the *Dirks* Court sought to protect from overreach with the personal benefit rule.

Frankly, getting one's arm around *Dirks* and *Salman* is infinitely easier than trying to parse through the logic of *Martoma I*. The above discussion does not do justice to either opinion. In any event, *Martoma I* was remarkable for at least four reasons.

First, the government achieved a result that it was previously denied of in *Newman* and *Salman*.[215] This illustrates the government's relentlessness in pursuing insider trading in any form with an expansive view of the law, even after getting "smacked down" by prior decisions.[216]

Second, the majority overruled *Newman* without the benefit of an en banc hearing, contrary to Second Circuit precedent.[217] The majority acknowledged this but justified its action by stating that a three-judge panel can overrule circuit precedent "'where an intervening Supreme Court decision casts doubt on the prior ruling.'"[218] In other words, the court was merely following the lead of the Court in *Salman*, although, as Judge Pooler rightly pointed out in her dissent—and as the majority implicitly acknowledged on rehearing—it was too great a stretch to conclude that *Salman* "cast doubt" by any reasonable measure on *Newman*'s relationship requirement.[219]

Third, it is not entirely unclear why the majority felt compelled to go as far as it did, unless it was nothing more than a desire to take the opportunity to gut a decision that the majority—and possibly other judges on the Circuit—concluded went too far.[220] Arguably, Martoma's conviction could have been upheld on a quid pro quo basis in view of the fact that one of the tippers received at least a $70,000 consulting fee, which formed the basis for the amended decision, and thus avoided the issue of the "meaningfully close personal relationship" requirement.[221] Additionally, *Salman* implicitly left the "meaningfully close personal relationship"

215. *See Martoma I*, 869 F.3d at 70.
216. *See generally id.*
217. *Martoma I*, 869 F.3d at 68 (citing Shipping Corp. of India v. Jaldhi Overseas Pte Ltd., 585 F.3d 58, 67 (2d Cir. 2009)).
218. *Martoma I*, 869 F.3d at 68.
219. *Id*. at 80 (Pooler, J., dissenting).
220. *See* Patel & Galloway, *supra* note 42, at 5.
221. *Martoma II*, 894 F.3d 64, 68 (2d Cir. 2017).

requirement intact.[222] The Supreme Court did not consider the issue it would have been a significant stretch for the majority to argue that *Salman* provided any support for its analysis.

Finally, the *Martoma I* court dramatically undercut the limiting principle of *Dirks* with the subjective intent to benefit standard, which was more clearly stated in the amended decision.[223] In so doing, the majority ostensibly adhered to *Dirks*. In reality, however, the majority arguably casted doubt on the viability of *Dirks*.

In sum, *Martoma I* replaced *Newman*'s enhanced relationship requirement with what appeared to be the subjective intent to benefit standard.[224] In doing so, the court effectively removed an important evidentiary layer of the government's case. In the process, the scales were decidedly tipped in the favor of the government, much to the consternation of the securities industry. However, the Second Circuit was not done attempting to clarify the personal benefit rule.

2. Martoma II[225]

After the court issued its decision, Martoma successfully petitioned the court for a rehearing.[226] The gravamen of his argument on rehearing was that the jury's instructions ran afoul of *Newman* by allowing the jury to find that a tipper receives a personal benefit from gifting inside information even where the tipper and tippee do not have a "meaningfully close personal relationship."[227]

Here is where things get more curious. The court sustained the conviction but on different grounds from the original case. Basically, the court acknowledged that the jury instructions were inconsistent with *Newman*, not because they omitted the term "meaningfully close personal relationship," but because they allowed the jury to convict solely on the evidence of a friendship without requiring a quid pro quo relationship or an intent by the

222. *See* Salman v. United States, 137 S. Ct. 420, 426–27 (2016).
223. *See Martoma II*, 894 F.3d at 85; *see also Martoma I*, 869 F.3d at 72–73.
224. *See Martoma I*, 869 F.3d at 72–73.
225. *Martoma II*, 894 F.3d at 64.
226. *See id.*
227. *Id.* at 68.

tipper to benefit the tippee.[228] At the same time, the majority made it clear that there was no need to instruct the jury on the "gift theory" because the jury could also find a personal benefit based on the intent to benefit standard.[229]

Interestingly, the majority opinion is devoid of any reference to the securities industry, as was the case in *Dirks* and even *Newman*. Moreover, the majority did not trouble itself with analyzing how the intent to benefit standard was consistent with *Dirks*' limiting principle other than to point out, as it did in the original opinion, that a prerequisite for personal benefit is that the tipper has an expectation that the tippee will trade on the MNPI.

The court went on to hold that the error did not affect Martoma's substantial rights because the government presented compelling evidence that at least one tipper shared a relationship, thus suggesting a quid pro quo with Martoma.[230] That relationship was the $70,000 consulting fee that was paid to one of the doctors, which was in evidence at the trial and arguably could have ended the inquiry in the original case.[231]

The majority focused extensively on the intent to benefit language contained in its original decision as a means to satisfy the "meaningfully close relationship" requirement in the gift-giving context. The majority concluded that its view was consistent with *Dirks*, and essentially that "additional evidence of the tippee-tipper relationship" is not required in every case for a personal benefit to exist.[232]

In effect, the *Martoma II* court reversed its prior ruling that abrogated *Newman*'s "meaningfully close personal relationship" requirement, and added an alternate basis for establishing personal benefit based on the intent of the gift-giver, which it found to be consistent with the *Newman* requirement and, by implication, with *Dirks*.[233] In an about face, the majority acknowledged that it did not need to decide whether *Newman*'s requirement was inconsistent with *Salman*.[234]

228. *Id.* at 77–78.
229. *Id.* at 78.
230. *Id.*
231. *Id.* at 68, 78.
232. *Id.* at 75.
233. *See id.* at 77–78.
234. *Id.* at 71.

In sum, as one commentator succinctly put it, "the majority read *Newman* to require evidence of a personal benefit to the tipper, which can be established through *either* evidence of a meaningfully close or *quid pro quo* relationship between the tipper and tippee *or* evidence that the tipper intended to benefit the tippee by sharing [MNPI]."[235] It is hard to imagine any set of facts that could trigger the application of the "meaningfully close personal relationship" requirement and yet not be addressed by the lesser intent to benefit standard. Thus, it is fair to conclude that the majority embraced *Newman*'s "meaningfully close personal relationship" requirement while effectively rendering it meaningless as a practical matter.[236] Indeed, *Newman* was replaced with a test that effectively only required the government to adduce evidence that MNPI was intentionally disclosed by a tipper with the expectation that the tippee would trade on it.[237]

One can only speculate about the majority's state of mind from a tactical perspective. Perhaps the majority was "providing a basis" for denying an *en banc* petition by reaffirming *Newman*'s relationship requirement and also concluding that even under *Newman*, "the personal benefit test is met when a tipper gifts inside information with the intention to benefit the tippee."[238] Another entirely plausible but less Machiavellian suggestion is that the majority did not have a hidden agenda and simply recognized that they made a mistake in the original decision and wanted to get the law "right" the second time around, irrespective of the potential for an en banc hearing. Simply put, the Second Circuit may have been tired of struggling over the personal benefit rule. In any event, the en banc petition was denied.

The court's holding in *Martoma II* concerning the newly introduced intent to benefit standard ultimately came down to its

235. Martine Beamon et al., *Development in Insider Trading Liability*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (July 25, 2018), https://corpgov.law.harvard.edu/2018/07/25/development-in-insider-trading-liability/ [https://perma.cc/M43N-VUNE] (emphasis in original).

236. *See id.*

237. Salman v. United States, 137 S. Ct. 420, 427 (2016).

238. David Miller & Grant MacQueen, *Martoma – The Latest Critical Insider Trading Decision*, LAW360 (June 27, 2018, 1:03 PM), https://www.law360.com/articles/1057759/martoma-the-latest-critical-insider-trading-decision [https://perma.cc/Q4M3-853M].

textual reading of a single sentence in *Dirks*.[239] There is little value in relaying the analysis here because it is difficult to parse and the majority acknowledged that it was ambiguous.[240] Suffice it to say, the majority interpreted the sentence as stating that the intent to benefit is a stand-alone personal benefit under *Dirks*.[241] According to the dissent, the correct interpretation of the sentence is that the intention to benefit requires proof of "a relationship between the insider and the recipient that suggests . . . an intention to benefit the particular [tippee]."[242]

It is not unusual for judges to interpret language differently. For purposes of this Article, the important point is that the majority's interpretation lends itself to an inherently subjective analysis by the fact finder, whereas the dissent's interpretation requires an objective analysis and, by definition, is narrower because evidence of the requisite close relationship needs to be established.

The implications of this divergence in views is important for defendants caught up in the web of insider trading laws. Under the majority view, the government can establish personal benefit with evidence of the tipper's intent, and it is not required to provide evidence of the tipper-tippee relationship in every case.[243] As such, the majority removed—if not greatly stripped away—the substantiality provided by *Newman*'s "meaningfully close personal relationship" test.[244]

The dissent's view pivots off the limiting principle of *Dirks*. Judge Pooler stated that "[r]estricting proof of a personal benefit to objective evidence avoids turning the rule into a mere formality."[245] Like the majority in *Dirks*, it appears that Judge Pooler was concerned that insider trading laws could sweep too broadly and ensnare "legitimate" market participants in its web.[246] She was especially concerned that prosecutors could commence enforcement proceedings based on scant objective evidence.[247] Judge Pooler was

239. *Martoma II*, 894 F.3d at 74.
240. *Id.*
241. *Id.*
242. *Id.* at 84 (Pooler, J., dissenting) (alteration in original).
243. *Id.* at 74 (majority opinion).
244. *Id.*
245. *Id.* at 81 (Pooler, J., dissenting).
246. *See id.* at 81–82.
247. *See id.* at 82.

fighting to preserve the heart of *Newman*, that is, the need to establish clearer boundaries around government discretion and prosecution.[248]

While one can debate who got it right from a doctrinal perspective, it is clear is that *Martoma II* essentially replaced *Newman*'s objective relationship standard with the subjective intent to benefit standard.[249] In the process, the Martoma's of the world were given one less avenue to escape insider trading liability. However, market analysts and other securities industry professionals now faced greater prosecutorial risk if they traded on MNPI that was originally disclosed with the expectation that the recipient would trade on the information.

IV. PRACTICAL APPLICATION OF *MARTOMA* AND *NEWMAN*

For illustration purposes, the difference between the inquiry under the *Martoma* cases and *Newman* is illustrated by the following (slightly edited) hypothetical and discussion provided by Gregory Morvillo, a well-known securities defense lawyer who represented Newman along with other lawyers.[250]

Suppose a junior corporate official, who is relatively new to her job, reveals more about her company than she should, knowing that the investment professional is going to trade because that is what investment professionals often do. Morvillo posits that under the *Martoma* cases, her conduct could be considered insider trading; but under *Newman*, it would not. He goes on to flesh out his conclusions as follows:

The *Martoma* cases ask the following: (1) was the disclosure intentional? (Answer: yes); (2) did the insider have an expectation the recipient was going to trade? (Answer: yes); (3) could this be considered a gift? (Answer: yes, because what is a gift but the intentional giving of information without an expectation of something in return.) Thus, under the *Martoma* cases, both parties could be convicted of insider trading.

Newman asks the following: (1) was the disclosure intentional?

---

248. *See id.*

249. *See generally id.* at 76–78 (majority opinion).

250. Gregory Morvillo, Martoma*: The Second Circuit's Unnecessary Mess*, NYU: COMPLIANCE & ENFORCEMENT (Sept. 7, 2017), https://wp.nyu.edu/compliance_enforcement/2017/09/07/martoma-the-second-circuits-unnecessary-mess/ [https://perma.cc/2RBN-KLLZ].

(Answer: yes); (2) did the insider have an expectation the recipient was going to trade? (Answer: yes); (3) could this be considered a gift to a trading relative or friend? (Answer: no, the relationship did not rise to the level of a "meaningfully close personal relationship," because the relationship was not of the nature or kind where one party would commit fraud and give the other a gift of potentially millions of dollars. In the real world, that only happens when the tipper and tippee have a very close relationship.)[251]

In any event, Morvillo acknowledges that there may be circumstances where the investor relations person and analyst may be convicted of insider trading.[252] However, his concern, like that of Judge Pooler, is that *Martoma II* sweeps too broadly.[253] Each would advocate "close" cases slipping the net of tippee liability, whereas the majority in *Martoma II* casted a wider net.

This takes us full circle. The majority was unwilling to let people like Martoma slip through the narrow net cast by the court in *Newman*. Judge Pooler—while she personally may have found Martoma's actions abhorrent and certainly unfair—was not willing to subscribe to a rule that could ensnare securities professionals that were providing legitimate market services.[254]

V. SUMMING UP TWO WORLD VIEWS—OR AT LEAST TWO DIFFERENT APPROACHES

Hypotheticals and textual readings of sentences aside, it is clear is that the panels in *Newman* and the *Martoma* cases took different approaches to determining where to draw the boundaries of tippee liability in the gift-giving context—one broad, the other narrow. What is also clear is that neither the narrow rule of *Newman* nor the broad rule of *Martoma* is satisfactory to both the government and participants in the securities industry.[255] Indeed, depending on one's perspective, innocent people may be captured by a broad rule and wrongdoers may escape under a narrower rule.

---

251. *Id.*
252. *Id.*
253. *Id.*
254. *See Martoma II*, 894 F.3d at 81–82 (Pooler, J., dissenting).
255. *See* Matt Levine, *Everything is Insider Trading Again*, BLOOMBERG OPINION (Aug. 24, 2017, 12:14 PM), https://www.bloomberg.com/opinion/articles/2017-08-24/martoma-ruling-shows-that-everything-is-insider-trading-again [https://perma.cc/V4H2-YC8Z].

There does not appear to be any middle ground.

Everyone knows that insider trading is fundamentally unfair, but defining what constitutes insider trading in the world of information sharing between providers and recipients in the securities industry is difficult. Section 10(b)/rule 10b-5 prohibit fraud, not unfairness *per se*. The generality of section 10(b)/rule 10b-5 coupled with the lack of clear guidance from Congress (assuming that is even possible), means that the courts will have to draw the line. Courts should strive to connect their holdings to doctrine, and remain cognizant of the fact that serious consequences will result from where the lines are drawn. The Second Circuit made three attempts in three years at crafting a rule, and it struggled in the process.[256] While some of the Circuit's angst may be attributable to miscalculations on doctrine that needed correcting, it is arguable that the subject of insider trading simply does not lend itself to a neat analysis, as it is amorphous and confusing. Additionally, although the *Martoma II* majority may have regarded *Dirks* as outdated, it was "stuck" with that decision and had to navigate its way through it as best it could.

The question of who got it right is unanswerable because the underlying law of insider trading in the context of tippee liability does not lend itself to a neat analytical framework. It is fair to argue that the majority and the dissent in *Martoma II* were both right and wrong. There is no "one size fits all" answer, which lawyers and academics have pursued since time immemorial. Stated another way, the only right answer is the answer provided by the court that issues the final decision. And for now, that is the *Martoma* cases.

Boiling down the different views of the majorities and the dissents in the *Martoma* cases on the standard of evidence necessary to infer a personal benefit to whether tippee liability should be narrow or broad may be too simplistic for many. It would be gross speculation to conclude, for example, that Judge Pooler takes a narrow view of insider trading in general. But it is clear that, based on her dissent in *Martoma II*, she at least believes it has

256. *See Martoma II*, 894 F.3d at 77–78; United States v. Salman, 792 F.3d 1087, 1092–93 (9th Cir. 2015); United States v. Newman, 773 F.3d 438, 450 (2d Cir. 2014), *abrogated by* Salman v. United States, 137 S. Ct. 420 (2016).

its limitations.[257] The same can probably be said for the *Newman* court. On the other hand, the approach of the majority opinions in the *Martoma* cases appear to have taken an approach more consistent with the Second Circuit's historically expansive view of the reach of insider trading law. In this sense, it is fair to argue that the majority regarded *Newman* as an outlier in Second Circuit insider trading jurisprudence, and what remained after *Salman* needed to be set aside.

Whether the majority and dissent started with different "world views" that dictated the outcomes is unclear. What is clear is that, at a foundational level, the majority and dissenting opinions in the *Martoma* cases reflect divergent views—which have drastically different consequences—as to the reach of insider trading law in the context of tippee liability.

VI. THE IMPLICATIONS OF THE *MARTOMA* CASES AND OTHER CONSIDERATIONS

Unless the Supreme Court takes the case up, which appears especially unlikely because there is no discernable split in the circuits, *Martoma II* stands as the law today in the Second Circuit. Interestingly, in criminal cases, the government can avoid the personal benefit rule entirely, though it has not used that power often. Regardless, after the *Martoma* cases, the government's evidentiary burden in gifting cases has been greatly eased and its prosecutorial discretion widened, which has important consequences for the securities industry.[258] Also, the SEC has the authority to bring civil insider trading cases in its administrative law courts, which it has increasingly done since the Dodd-Frank Wall Street Reform and Consumer Protection Act expanded the

257. *See Martoma II*, 894 F.3d at 81–84 (Pooler, J., dissenting).

258. *See* David Chaiken & Paul Monnin, *Why Insider Benefit is Irrelevant to Criminal Insider Trading*, LAW360 (May 19, 2017, 1:52 PM), https://www.law360.com/articles/923249/why-insider-benefit-is-irrelevant-to-criminal-insider-trading [https://perma.cc/9JMU-UT8M]. The authors make the point, which they argue is "largely ignored by most practitioners, academics and the legal press," that the DOJ may ignore the benefit requirement by prosecuting under alternative statutes, such as the criminal securities fraud statute, 18 U.S.C. § 1348, rather than "per tradition," under section 10(b)/rule 10b-5. *Id.* I have taken the liberty of interpreting the "per tradition" phrase to mean the government does often resort to these statutes for insider trading *per se*.

universe of defendants that may be sued in administrative proceedings, and the available remedies.[259]

What we do know is that after the *Martoma* cases, the government's evidentiary burden in gifting cases has been greatly eased and its prosecutorial discretion widened, which has important consequences for the securities industry. *Salman* ended the tangible value requirement of *Newman*.[260] It is debatable whether the "meaningfully close personal relationship" requirement has disappeared entirely by virtue of the *Martoma* cases, although Judge Pooler and Martoma's lawyers appear to believe it has.[261] In any event, the requirement has been significantly mitigated and, as the majority pointed out, the bar to prove personal benefit is now relatively low. It will be interesting to see what courts outside the Second Circuit do with the *Martoma* cases, if anything.

Remote tippees can take some solace from the fact that *Salman* and the *Martoma* cases left largely untouched the second requirement of *Newman*, which requires the government to introduce concrete evidence that the tippee knew (or did not avoid knowing) of the personal benefit.[262] At first blush, this appears to be a fairly heavy burden. This may explain why the United States Attorney did not indict some of the "remote" tippees in the *Collins* case.[263] *Newman*-like remote tippees can take solace from this, provided that the Second Circuit does not water down the knowledge requirement in light of the fact that the "meaningfully close personal relationship" requirement has been essentially jettisoned. But that remains to be seen. Indeed, based on the government's track record in insider trading cases, it will likely attempt to chip away at *Newman*'s knowledge requirement in future cases.

While *Newman*, *Salman*, and the *Martoma* cases involved criminal prosecutions, the doctrine that has emerged from these cases applies equally to civil proceedings, especially with the

---

259. Gideon Mark, *SEC and CFTC Administrative Proceedings*, 19 PA. J. CONST. L. 45, 46 (2016).
260. Salman v. United States, 137 S. Ct. 420, 438 (2016).
261. *See Martoma II*, 894 F.3d at 76.
262. *See* United States v. Newman, 773 F.3d 438, 452–53 (2d Cir. 2014), *abrogated by* Salman v. United States, 137 S. Ct. 420 (2016).
263. *See* Feuer & Golmacher, *supra* note 32.

different burden of proof, which presents an interesting question that will be left to others to explore further.[264] All indications are, however, that the doctrine applies to civil cases.[265] While the Agency might dispute it, it has a decided "home court advantage" in terms of the legal basis for tippee liability, which only increased by virtue of the *Martoma* cases.

Finally, there is an obvious lesson to be learned here for participants in the securities industry. The *Martoma* cases greatly increased the risks for participants who trade on MNPI. Firms and individuals who chose to place their faith in the government and the courts to protect them from insider trading prosecutions may find themselves sadly disappointed. Compliance programs that are aimed at detecting and preventing securities law violations will certainly need to be adjusted for insiders and recipients of MNPI in order to account for the broad tippee liability standard established in the *Martoma* cases.[266]

The guidance to insiders is fairly straightforward: do not communicate MPNI to anyone outside the company, especially if the insider is deriving some personal benefit from the communication, such as providing a Christmas gift to the doorman or the plumber in lieu of payment for services rendered. The potential liability and costs of such action are too high. In reality, it is more complicated than this for many market professionals who thrive on information, especially for traders who will want to know "exactly" what is legal after the *Martoma* cases and what is not.

In the author's experience, when it comes to preventing violations of federal securities law, well-crafted and enforced compliance programs are hardly fool proof, but if they are meaningful, they can help to mitigate penalties directed at firms. In any event, the financial pressures inherent in the securities industry remain unaffected by the *Martoma* cases. The means to achieve financial reward have been affected, and at least made riskier. It will be interesting to see whether the *Martoma* cases have a material impact on information sharing and trading practices in the Second Circuit and elsewhere. In any event, insider trading law for tippers and tippees is now a more dangerous trap

264. *Dirks* involved a civil prosecution. *See* Dirks v. SEC, 463 U.S. 646, 650 (1983).
265. *See* Eisenberg, *supra* note 93.
266. *See Martoma II*, 894 F.3d at 74.

for the blind or unwary, as Representative Christopher Collins and his co-defendants are poignantly aware of now.

CONCLUSION

In *Newman* and the *Martoma* cases, the Second Circuit struggled to define tippee liability, but they dealt with a law that does not lend itself to the clear drawing of lines. Having said this, *Salman* took care of the unnecessary overreach by the *Newman* court on the pecuniary/tangible benefit requirement. The *Martoma* cases initially overreached by rejecting the "meaningfully close personal relationship" requirement based on *Salman*, and then complicated matters worse by reinstating the relationship requirement and retaining its intent to benefit standard. Over the course of three years, the underlying rule within the law of tippee liability broadened dramatically, which undoubtedly caused great uncertainty and confusion in the securities industry and the government.

Further, the *Newman* court and Judge Pooler approached tippee insider trading from a narrow perspective, whereas the majorities in the *Martoma* cases approached it from a broad perspective.[267] Whether each started from the premise that insider trading law should be narrowly or broadly construed is largely beside the point. What is important, however, is where the Second Circuit ended up, at least for now, and how it struggled to get there.

For now, *Martoma*'s relaxed subjective standard for determining personal benefit is the law in the Second Circuit, and along with that comes a likelihood of more insider trading prosecutions. Naivety aside, one would think the government should be cautious about opening the floodgates in light of *Dirks*' limiting principle. This does not mean that participants in the securities industry who are paying attention to the Martoma cases should not be unnerved. Rather, they should be concerned because the government has broad discretion over when to bring enforcement actions, and that power was bolstered by the demise of *Newman*'s personal benefit requirements. This is the legacy of the *Martoma* cases, irrespective of what one thinks of the decision.

267. *See id.*