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Outside Counsel

What's Left of the 'Personal Benefit' Requirement After 'U.S. v. Martoma'?

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On June 21, 2019, Judge Paul G. Gardephe of the Southern District of New York vacated the guilty plea of Richard Lee, a former manager at SAC Capital. Lee had pleaded guilty in 2013 to insider trading, related to the purchase of Yahoo stock based on insider tips about imminent collaboration between Yahoo and Microsoft. Judge Gardephe vacated Lee's guilty plea because his plea allocution did not establish his knowledge of any "personal benefit" that corporate insiders received as a result of providing him with this confidential information. Judge Gardephe concluded that "under the unusual circumstances of this case," namely the fact that the personal benefit test

By **Benjamin Gruenstein**

had been changed so drastically by the Second Circuit and the Supreme Court between Lee's plea and sentencing, his plea could not stand. Unfortunately for Lee, however, it is too early to celebrate. Given the significant weakening of the personal benefit test since 2013, the likelihood that prosecutors will be able to satisfy this requirement to prove Lee's guilt is high.

The 'Martoma' test eliminates any meaningful burden on the government to show an actual benefit gleaned by the tipper.

As Judge Gardephe recognized, the personal benefit requirement for insider trading liability has been defined, redefined and threatened multiple times since Lee's plea in 2013. The requirement was first introduced in *Dirks v. SEC*, 463 U.S. 646 (1983), as an element of "tippee" liability, which only occurs "when the insider has breached his fiduciary duty … and the tippee knows or should know that there has been a breach." The Supreme Court held that "[a]bsent some personal gain, there has been no breach of duty." Thus, for the tippee to be found guilty of insider trading, a jury must conclude that the tipper who provided that information did so for his own "personal benefit" rather than to further the interests of the individuals to whom the information ultimately belongs. *Dirks* emphasized that courts should rely on "objective facts and circumstances" to evaluate whether an insider personally benefits from a particular disclosure, so as to provide predictability and guidance "for those whose

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daily activities must be limited and instructed by the SEC's inside-trading rules."

The personal benefit test remained vague until 2014, when the Second Circuit, in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), clarified that a "personal benefit" to the tipper can only be inferred where there is "a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." In that case, the defendants were charged with trading as tippees on information that was passed along through acquaintances, including networks of college alumni and church members. *Newman* held that these relationships were insufficient to demonstrate liability, because if the Government simply had to demonstrate a casual connection between tipper and tippee, then "the personal benefit requirement would be a nullity." Judge Gardephe acknowledged the importance of this doctrinal development in his recent decision, in response to the government's argument that *Newman* did not transform the personal benefit requirement. Judge Gardephe chided the government for "improperly minimiz[ing] the significance of *Newman*," and noted that "[p]rior to *Newman*, the personal benefit requirement for tippee liability was not clear."

The personal benefit test was refined further by the Supreme Court in its 2016 decision in *Salman v. United States*, 137 S. Ct. 420 (2016). In that case, the tipper was an investment banker, Maher Kara, who gave information to his brother, Michael. Maher testified at trial that he had given the information to Michael with the knowledge that Michael would trade on it to "fulfil[l] whatever needs he had." Michael then passed the information along to Bassam Salman, another relative, who was convicted by a jury of insider trading in the Northern District of California in 2013. The Supreme Court affirmed the conviction. In so doing, it left untouched *Newman*'s instruction that "personal benefit" to the tipper can only be inferred where there is "a meaningfully close personal relationship that generates an exchange that is objective [and] consequential," but partially abrogated *Newman* by adding that "[t]o the extent that the Second Circuit in *Newman* held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to a trading relative, that rule is inconsistent with *Dirks*."

While the *Salman* decision represented a weakening of the personal benefit test that had been articulated in *Newman*, the Second Circuit went even further in *United States v. Martoma*, 894 F.3d 64 (2d Cir. 2017), and so far as to flip the test on its head by effectively changing it from being a requirement of personal benefit to the *tipper* to a personal benefit to the *tippee*. In that case, Mathew Martoma was accused of trading on inside information about a clinical trial involving an Alzheimer's drug, which was being developed by pharmaceutical companies Elan and Wyeth. Dr. Sidney Gilman, one of the chairs of the trial, provided information about the trial to Martoma, who then traded on the companies' securities in advance of the public disclosure of the study's results. Martoma was convicted, and appealed on the basis that the jury instructions did not require a showing that he and Dr. Gilman shared a "meaningfully close personal relationship," as called for by *Newman*. The Second Circuit affirmed the conviction, holding that a jury could find that a tipper derived a "personal benefit" from providing inside information simply if it had evidence that the tipper intended to benefit the tippee. *Martoma* thus weakened the personal benefit test by expanding it to include *either* a meaningful, personal relationship suggesting a quid pro quo *or* a tipper's gifting of confidential information with the intent to benefit the tippee.

Courts in the Southern District of New York are now instructing juries that intent to benefit the tippee is sufficient to establish the personal benefit requirement. In *United States v. Chow*, 17-cr-667 (S.D.N.Y. 2018), a case in which a partner of a private equity firm provided a material, nonpublic tip to his friend and business associate, the court instructed the jury on the personal benefit test as follows:

> The benefit does not need to be financial or tangible in nature. It could include, for example, a *quid pro quo* exchange of information, maintaining a useful networking contact, or improving the defendant's reputation in a way that it will translate into obtaining future financial or business benefits. *In addition, a defendant receives a personal benefit when he discloses inside information with an intention to benefit the recipient*, such as when he discloses inside information as a gift to a trading relative or friend. (emphasis added).

Although the court went on to "caution … that an insider's disclosure of material nonpublic information, standing alone, does not establish this benefit factor," it is difficult to imagine a scenario in which this expansive requirement would not be met.

The *Martoma* test eliminates any meaningful burden on the government to show an actual benefit gleaned by the tipper. It also no longer requires an *objective* showing of a close personal relationship, which was central to the *Dirks* decision, which warned against letting juries "read the parties' minds." The implications of this development are stark. The expanded personal benefits test poses liability risks for individuals who make legal trades within the scope of their employment or personal activities. *Dirks* recognized that professional traders' thorough digging for and analysis of information before making a trade is "necessary to the preservation of a healthy market." Conversely, the fear of prosecution may therefore have an enormous chilling effect on legal activity.

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When the Supreme Court declined to hear Martoma's appeal last month, it missed an opportunity to clarify the law going forward in the Second Circuit. In a world where corporate insiders can share information outside the company for many legitimate reasons, those insiders—and the recipients of information from them—risk unfair prosecution absent a narrow, objectively defined personal benefit requirement.