Insider Trading Law Alert: Better The Devil You Know? Tipping Liability, Martoma and the Rise of 18 U.S.C. § 1348

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Insider trading has frequently been splashed across headlines in recent months, with a congressman, an NFL player, a comedy writer, and a Silicon Valley executive all facing charges.[1] In the background of these headlines are two legal developments that give the government greater flexibility to successfully litigate future insider trading cases, particularly those involving tipping.[2]

First, the US Court of Appeals for the Second Circuit's revised decision in *United States v. Martoma*[3] embraced a broad theory of liability under Section 10(b) of the Securities Exchange Act and Rule 10b-5 (hereinafter, collectively, "Section 10(b)") that prohibits a party from tipping with an "intent to benefit" the recipient. Second, when prosecutors have pursued tipping cases under 18 U.S.C. § 1348, a criminal securities fraud provision adopted as part of the Sarbanes-Oxley Act of 2002, courts have interpreted this newer securities fraud statute to have less stringent requirements than Section 10(b).

These two developments could lead the government to take a more aggressive stance on tipping charges in the future, and both finance professionals and lawyers need to be aware that the ground may be shifting under them.[4]

United States v. Martoma

In *United States v. Martoma*, the Second Circuit grappled with the question of whether liability under Section 10(b) attaches when a tipper passes along material nonpublic information to another person, even a casual acquaintance, who later trades on that information, and the tipper receives no apparent financial reward in return. Reflecting the uncertainty in this area, the Second Circuit issued an initial opinion in 2017 and then a revised panel opinion nine months later. This revised opinion changed the landscape of tipping jurisprudence, at least in the Second Circuit.

By way of background, the US Supreme Court first addressed liability associated with the tipping of material nonpublic information in *Dirks v. SEC*.[5] The *Dirks* Court held that not all tippers and recipients of material, nonpublic information face liability for subsequent trading.[6] Instead, a tippee assumes the tipper's fiduciary duty, and thus is prohibited from trading, only where the tipper "has breached his fiduciary duty . . . by disclosing the information to the tippee. . . ."[7] Further, the tipper's

tip is a breach of fiduciary duty only where the tipper receives a "personal benefit" from the disclosure.[8] The *Dirks* Court explained: "the test is whether the insider personally will benefit, directly or indirectly, from the disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach" by the tippee.[9]

When the tipper receives money, other financial remuneration or some other thing of value (like lobsters or an iPhone[10]) in exchange for sharing material nonpublic information, courts and juries have had little trouble finding a sufficient "personal benefit" to establish liability. The issue of liability in the absence of any apparent financial or other tangible benefit to the tipper is more difficult and has bounced back and forth to and from the Supreme Court:

- In 1983, in *Dirks*, the Supreme Court wrote that a gift of confidential information to a trading relative or friend—where the tip and the trade resemble trading by the tipper, followed by a gift of the profits to the recipient—is sufficient to establish tipping liability.[11]
- Thirty years later, in *United States v. Newman*, the Second Circuit attempted to cabin the reach of *Dirks*, holding that, under the gift theory, there must be both evidence of a "meaningfully close personal relationship" between the tipper and the tippee, and evidence that the personal benefit reflects "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[12]
- In 2016, in *Salman v. United States*,[13] the Supreme Court rejected Newman's requirement of proof of potential pecuniary gain in the context of gifts of information to trading relatives or friends, holding that "when a tipper gives inside information to a 'trading relative or friend,' the jury can infer that the tipper meant to provide the equivalent of a cash gift."[14]

Enter *United States v. Martoma*. A doctor who chaired the safety monitoring committee for the clinical trial of an Elan and Wyeth experimental drug to treat Alzheimer's disease provided Martoma with information demonstrating the drug was not effective; Martoma then sold Elan and Wyeth securities and engaged in other transactions related to the companies.[15] Martoma was convicted of insider trading in 2016.[16]

On appeal, Martoma challenged the jury instructions and the sufficiency of the evidence. In its August 2017 opinion (*Martoma I*), the Second Circuit panel took a broad view of the Supreme Court's decision in *Salman* and found not only that the Court rejected *Newman*'s "pecuniary gain" requirement, but also that the "meaningfully close personal relationship" standard in *Newman* was no longer good law.[17] The *Martoma I* panel held that "an insider or tipper personally benefits from a disclosure of confidential information *whenever* the information was disclosed with the expectation that the recipient would trade on it . . . and the disclosure resembles trading by the insider followed by a gift of profits to the recipient."[18] (emphasis added). The panel then held that there was no clear error in the jury instruction and there was sufficient evidence to convict Martoma.[19]

In its revised opinion, *Martoma II*, the panel changed its analysis. The panel revived the "meaningfully close personal relationship" standard, reasoning that it was simply an articulation of already established theories for showing an inferred benefit to the tipper.[20] More important, however, the panel embraced a separate and distinct theory of tipping liability predicated not on the parties'

relationship, but on whether the tipper intended to benefit the tippee, which (the panel remarked) could be inferred from circumstantial evidence.[21]

The panel based its embrace of the "intent to benefit" theory on a close grammatical analysis of the following sentence in Dirks: "For example, there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, *or an intent to benefit the particular recipient*."[22] (emphasis added). The panel acknowledged that the comma and the word "or" in the sentence were ambiguous.[23] However, the panel chose to interpret the separate clauses to articulate *two separate and distinct ways of proving a personal benefit*: 1) a personal relationship suggesting a quid pro quo, *or* 2) an intent by the tipper to benefit the tippee.[24]

The possible breadth of this holding, though downplayed by the panel, is clear from the hypothetical the panel embraced:

> For example, suppose a tipper discloses inside information to a perfect stranger and says, in effect, you can make a lot of money by trading on this. Under the dissent's approach, this . . . would be insufficient to show a breach of the tipper's fiduciary duty to the firm due to the lack of a personal relationship. Dirks and Warde do not demand such a result. Rather, the statement "you can make a lot of money by trading on this," following the disclosure of material non-public information, suggests an intention to benefit the tippee in breach of the insider's fiduciary duty.[25]

Under the panel's hypothetical, both the tipper and the tippee would be liable if the tippee traded on the information. As Judge Pooler pointed out in her dissent, this standard circumvents hurdles the government previously had to overcome, including proof of a close personal relationship between the tipper and the tippee or some other meaningful benefit for the tipper from the tip.[26] Instead, all the government would have to prove to establish tipping liability is that the insider gave material, nonpublic information "intending to benefit the recipient." And as the panel noted, intent to benefit the tippee can be inferred from circumstantial evidence, not just explicit statements of the kind put forth in the panel's hypothetical.[27]

Given the nebulous standard of whether the tipper "intended to benefit" the tippee and given the ability to infer this intent from circumstantial evidence, *Martoma II* creates considerable uncertainty as to where the line of liability may be drawn in future cases.

The Rise of 18 U.S.C. § 1348 to Prosecute Insider Trading

Against the backdrop of uncertainty under Section 10(b) tipping jurisprudence, prosecutors have begun increasingly to charge insider trading, including in tipping cases, under 18 U.S.C. § 1348 in tandem with Section 10(b). Section 1348, which was adopted in the Sarbanes-Oxley Act, mirrors the mail and wire fraud statutes. Courts have interpreted the law to impose less stringent requirements on the government than traditional tipping jurisprudence.[28]

For example, in tipping cases brought under Section 10(b), it must be shown that the tipper 1) intentionally or recklessly communicated, 2) material, nonpublic information, 3) in breach of a fiduciary duty or confidentiality owed to shareholders or the source of the information, 4) for a

personal benefit to the tipper, 5) with scienter.[29] In contrast, under Section 1348, courts have held that the government need only prove 1) fraudulent intent, 2) a scheme or artifice to defraud, and 3) a nexus with a security.[30] Thus, the fiduciary duty and personal benefit requirements that have been constructed under Section 10(b) tipping jurisprudence need not be proven in Section 1348 cases. Because Section 1348 broadly covers a scheme or artifice to defraud or otherwise obtain money or property through fraud, prosecutors have used Section 1348 to charge various theories of insider trading, including the classical,[31] misappropriation[32] and tipping[33] theories of liability.

The government's use of twin charges under Section 10(b) and Section 1348 has increased over the years and appears to be paying off for the government. In one such recent case, *United States v. Blaszczak*, defendant Worrall, who worked at the Centers for Medicare & Medicaid Services (CMS), provided information about proposed changes in CMS reimbursement practices to Blaszczak, who shared it with Deerfield Capital partners Olan and Huber. At trial, Judge Kaplan rejected proposed jury instructions for the Section 1348 charges that would have required the jury to find both that Worrall breached his fiduciary duty in exchange for a personal benefit and that the tippees knew of the benefit and breach.[34] The tippees were each convicted on the Section 1348 charges but acquitted on the Section 10(b) charges.[35] The case is currently being appealed to the Second Circuit.[36]

Notably, an October 2018 law review article written by the Department of Justice Fraud Section chief and assistant chief notes that "the case law surrounding section 1348 offers prosecutors something of a fresh start in interpreting a securities fraud statute. Section 10b-5, for all of its versatility, has been interpreted so extensively that the case law underlying it is, at times, unhelpful to the government."[37] The article further notes that "a wide variety of [10b-5] cases across the circuits [] can cause confusion for prosecutors and judges alike. Section 1348 . . . offers a simpler approach."[38] The authors also highlighted that Section 1348 has a lower scienter requirement (knowingly) than 10b-5 (willfully), does not require a purchase or sale of a security as 10b-5 does, and has a longer maximum sentence (25 years) than 10b-5 does.[39]

Conclusions

The law around tipping has been in flux for the past several years, and will likely continue to be in flux as the Second Circuit and other courts grapple with complex issues relating to the Supreme Court's decision in *Salman* and the Second Circuit's decisions in *Newman* and *Martoma*. For now, *Martoma II* has embraced a broad theory that tippers are liable when they give material, nonpublic information to a tippee with an intent to benefit the tippee, which can be proven based on circumstantial evidence. Judge Pooler's strong dissent insisting that this theory is not consistent with precedent suggests that the issue is not settled. And indeed, Martoma has filed a petition for certiorari,[40] leaving open the possibility that the Supreme Court will soon weigh in on these issues again.

In light of this shifting case law, the government has turned to another more versatile tool in its belt, 18 U.S.C. § 1348. In light of the uncertainty presented in Section 10(b) and 10b-5 law and the lower bar presented by the elements of Section 1348, tipping charges under Section 1348 may become increasingly more common.

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1. Press Release, Sec.'s & Exch. Comm'n, *SEC Charges NFL Player and Former Investment Banker with Insider Trading* (Aug. 29, 2018); Press Release, Sec.'s & Exch. Comm'n, *SEC Charges U.S. Congressman and Others with Insider Trading* (Aug. 8, 2018); Press Release, Sec.'s & Exch. Comm'n, *SEC Detects Silicon Valley Executive's Insider Trading* (July 24, 2018).

2. Tipping occurs when an insider, the "tipper," gives material, nonpublic information to another person, the "tippee," and the tippee then trades on that information.

3. *United States v. Martoma*, 894 F.3d 64 (2d Cir. 2017) (hereafter *Martoma II*).

4. As of this publication, a cert petition is pending before the US Supreme Court in *United States v. Martoma*. *See generally* Petition for Certiorari, *United States v. Martoma*, 894 F.3d 64 (2d Cir. 2018) (No. 14-3599). The Court has not decided whether it will hear the appeal.

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

6. *Id.* at 659.

7. *Id.* at 660.

8. *Id.* at 662.

9. *Id.*

10. *See United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013).

11. *Dirks*, 463 U.S. at 664.

12. *United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014).

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

14. *Id.* at 427–28.

15. *Martoma II*, 894 F.3d at 69.

16. *Id.* at 68.

17. *United States v. Martoma*, 869 F.3d 58, 69 (2d Cir. 2017) (hereafter *Martoma I*).

18. *Id.* at 70 (citations and quotation marks omitted).

19. *Id.* at 67, 73–74.

20. *Martoma II*, 894 F.3d at 77.

21. *Id.* at 76.

22. *Dirks*, 463 U.S. at 646, 664 (1983).

23. *Martoma II*, 894 F.3d at 74.

24. *Id.* at 74.

25. *Id.* at 75.

26. *Id.* at 84 (Pooler, J., dissenting).

27. *Id.* at 76.

28. *See United States v. Mahaffy*, 693 F.3d 113, 125 (2d Cir. 2012); *United States v. Melvin*, 143 F. Supp. 3d 1354 (N.D. Ga. 2015); *United States v. Hatfield*, 724 F. Supp. 2d 321, 324 (E.D.N.Y. 2010); *United States v. Motz*, 652 F. Supp. 2d 284, 294 (E.D.N.Y. 2009); *United States v. Mahaffy*, No. 05-CR-613, 2006 U.S. Dist. LEXIS 53577, at *34 (E.D.N.Y. Aug. 2, 2006).

29. *SEC v. Obus*, 693 F.3d 276, 286, 289 (2d. Cir. 2012).

30. *See Mahaffy*, 693 F.3d at 125; *Motz*, 652 F. Supp. 2d at 294; *Hatfield*, 724 F. Supp. 2d at 324; *Mahaffy*, 2006 U.S. Dist. LEXIS 53577, at *34.

31. *See, e.g.*, Second Superseding Indictment at 21, 61, *United States v. Turino*, (No. 2:09-CR-132-RLH-RJJ), 2010 WL 4023000 (D. Nev., Mar. 24, 2010) (alleging a Section 1348 violation for violating a duty to shareholders by selling shares based on false statements and inside information).

32. *See generally* Complaint, *United States v. Fei Yan* (S.D.N.Y July 11, 2017) (No. 17-MAG-5156) (involving an alleged misappropriation case).

33. *See generally Melvin*, 143 F. Supp. 3d 1354 (involving a case of tipping).

34. *See* Stewart Bishop, *Medicare Insider Trading Case Beset By Flaws, 2nd Circ. Told*, Law360 (Mar. 11, 2019, 7:17 p.m.), https://www.law360.com/articles/1136609/medicare-insider-trading-case-beset-by-flaws-2nd-circ-told; Brief and Special Appendix for Defendant-Appellant Theodore Huber at 15–16, *United States v. Blaszczak* (2d Cir. Mar. 5, 2019) (No. 18-2811), 2019 WL 1177546, at *15–16.

35. Worrall, the tipper, was convicted of the wire fraud and conversion of government property, but acquitted on the charge of securities fraud. See Brendan Pierson, Four found guilty in insider trading case linked to U.S. health agency, Reuters (May 3, 2018), https://www.reuters.com/article/us-usa-crime-healthcare/four-found-guilty-in-insider-trading-case-linked-to-us-health-agency-idUSKBN1I42P4.

36. *See generally* Brief and Special Appendix for Defendant-Appellant Theodore Huber, *supra* note 34.

37. Sandra Moser and Justin Weitz, 18 *U.S.C. § 1348—A Workhorse Statute for Prosecutors*, 66 DOJ J. Fed. L. & Prac. 111, 120 (2018).

38. *Id.* at 120–21.

39. *Id.* at 121–122.

40. *See supra* note 4.

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