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## HOW INSTITUTIONAL DYNAMICS HAVE SHAPED INSIDER TRADING LAW

*The past decade has brought multiple significant decisions in insider trading law, but has not substantially clarified the line between legal and illegal trading. The author addresses how some degree of this lack of clarity can be traced to certain institutional dynamics at play in the courts issuing the relevant decisions. In particular, the author looks at the Second Circuit's uniquely strong preference for avoiding en banc review, and the Supreme Court's general preference for narrow decisions, and assesses the ways in which these dynamics have shaped and may continue to shape insider trading jurisprudence.*

By Brian A. Jacobs \*

The past decade has been a tumultuous period in insider trading law, particularly with respect to tippee liability. Prosecutors have aggressively pursued cases against defendants removed from the original sources of material non-public inside information, defendants have pushed back against these efforts, and courts have attempted to draw lines in difficult cases separating legal from illegal trading. Other articles have carefully charted the movements in insider trading doctrine during this period.<sup>1</sup> But one theme that has emerged from the

commentary is the acknowledgement that, because insider trading law is not defined by any statute, the law's development has been seemingly "haphazard."<sup>2</sup> That very haphazard development, moreover, has made it difficult for "scholars . . . to explain" why "the law developed as it did,"<sup>3</sup> as well as where the law may be heading.<sup>4</sup>

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<sup>1</sup> See, e.g., Peter J. Henning, *Making Up Insider Trading Law As You Go*, 56 WASH. U. J.L. & POL'Y 101, 102 (2018); Brian A. Jacobs & Priya Raghavan, *The Impact of Salman v. United States on Downstream Tippee Prosecutions*, 50 REV. SEC. COMMODITIES REG. 223, 224–27 (2017); Scott B. McBride, *Salman v. United States and its Impact on Insider Trading*

*Enforcement*, 50 REV. SEC. COMMODITIES REG. 125, 127–29 (2017).

<sup>2</sup> Henning, *supra* note 1, at 102.

<sup>3</sup> *Id.*

<sup>4</sup> Hervé Gouraige, *Do Federal Courts Have Constitutional Authority to Adjudicate Criminal Insider-Trading Cases?*, 69

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This article posits that one set of factors that has driven the development of insider trading law — and particularly some recent key court decisions — is the institutional dynamics of the courts issuing those decisions. In particular, in the absence of a clear governing statute or “congressional policy about why trading on material non-public information is a violation,”<sup>5</sup> two particular institutional dynamics, which are always present in the background, have recently played an outsized role in insider trading jurisprudence: First, the Second Circuit’s uniquely strong preference not to rehear cases en banc, and, second, the tendency of the Supreme Court under Chief Justice John G. Roberts to issue narrow decisions (especially when the Court sits with only eight justices). Seeing the development of insider trading law through this institutional lens, in addition to helping explain the recent case law, could also help to predict where the law may be headed in the coming years.

This article first discusses the relevant statutes and background case law. The article next summarizes the key recent insider trading cases and the ways in which institutional dynamics have impacted those decisions. The article finally assesses where insider trading law may be going.

## I. BACKGROUND: *DIRKS V. SEC* AND THE PROBLEM OF COMMON LAW CRIME

Unlike most other crimes, insider trading is not defined by any statute.<sup>6</sup> In general, the U.S. Department

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RUTGERS U.L. REV. 47, 103 (2016) (observing that “[m]embers of the financial services industry (all of whom must not be presumed to be criminals), especially their compliance officers, must continue to operate under conditions of extreme uncertainty with significant risks if their judgments should turn out wrong — the risks of either being prosecuted or not making money based on perfectly legal behavior”).

<sup>5</sup> Henning, *supra* note 1, at 102.

<sup>6</sup> Miriam H. Baer, *Insider Trading’s Legality Problem*, 127 YALE L.J. FORUM 129, 133 (2017) (“[W]hen we deal with criminal law, we expect statutes to play the starring role in legal analysis. For other types of offenses, criminal law more or less satisfies

of Justice and the U.S. Securities and Exchange Commission pursue insider trading cases as violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.<sup>7</sup> Section 10(b) prohibits the use of “any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe” “in connection with the purchase or sale of any security.”<sup>8</sup> Rule 10b-5, which the SEC promulgated pursuant to Section 10(b), provides in pertinent part that it is unlawful “[t]o employ any device, scheme, or artifice to defraud,” to “make any untrue statement of a material fact,” or to “engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.”<sup>9</sup>

Section 10(b) and Rule 10b-5 do not expressly prohibit insider trading. Rather, courts have interpreted Section 10(b) and Rule 10b-5 to give rise to two primary theories of insider trading liability: the “classical theory” and the “misappropriation theory.”<sup>10</sup> The classical theory prohibits a corporate insider from

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this expectation.”); *see also* Kenneth R. Davis, *Insider Trading Flaw: Toward A Fraud-on-the-Market Theory and Beyond*, 66 AM. U. L. REV. 51, 53 (2016) (“Since its inception, the law of insider trading has perplexed the legal community. . . . The problem arises in part because no U.S. statute defines insider trading.”); Robert J. Anello & Richard F. Albert, *Revisiting Criminal Insider Trading Liability*, 251 N.Y.L.J. No. 105 (June 3, 2014) (“Illegal insider trading is not defined by statute, but by an amalgamation of judicial opinions.”).

<sup>7</sup> *United States v. Whitman*, 904 F. Supp. 2d 363, 365 (S.D.N.Y. 2012) (noting that “most insider trading prosecutions (outside the context of tender offers) allege willful violations of Rule 10b-5 . . . pursuant to Section 10(b) of the 1934 Securities Exchange Act”).

<sup>8</sup> Securities Exchange Act of 1934, Section 10(b), codified at 15 U.S.C. § 78j(b).

<sup>9</sup> 17 C.F.R. § 240.10b-5.

<sup>10</sup> *See, e.g., Chiarella v. United States*, 445 U.S. 222 (1980) (classical theory); *Dirks v. SEC*, 463 U.S. 646 (1983) (classical theory); *United States v. O’Hagan*, 521 U.S. 642 (1997) (misappropriation theory).

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trading the securities of his or her corporation on the basis of material, non-public information; the misappropriation theory prohibits an individual from trading the securities of a corporation on the basis of material, non-public information that has been knowingly misappropriated. Pursuant to both of these theories, courts treat insider trading as, essentially, a kind of “deceptive device” in violation of Section 10(b) and Rule 10b-5. But because the elements of the crime are defined by judicial opinion, rather than by statute, insider trading is, “essentially, a common law crime, interpreted by the courts.”<sup>11</sup>

As to tippee liability — the focus of much recent case law — the Supreme Court set the standard in dicta in *Dirks*.<sup>12</sup> There the Supreme Court wrote that a tippee who trades on inside information may face liability if the tippee (1) acquired the information from a tipper who had a duty to disclose or abstain from trading and (2) knew that the information was disclosed in breach of the tipper’s duty.<sup>13</sup>

What amounts to a breach of duty by the insider/tipper? *Dirks* instructed courts “to focus on objective criteria, *i.e.*, whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit, that will translate into future earnings.”<sup>14</sup> *Dirks* elaborated that:

[t]here are objective facts and circumstances that often justify such an inference. For example, there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of non-public information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.<sup>15</sup>

At the same time, *Dirks* acknowledged that “[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts.”<sup>16</sup>

The foregoing passage — which subsequent case law discussed below has parsed in a manner usually reserved for legislation — leaves unanswered questions. Most importantly, while *Dirks* explicitly provides that a tip to a “trading relative or friend” is sufficient to meet the personal benefit test because such a “tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient [of the tip],”<sup>17</sup> *Dirks* provides scant basis for determining what constitutes “friendship” sufficient to result in a benefit to the tipper for these purposes.

## II. NEWMAN: A NARROW VIEW OF DIRKS

In *United States v. Newman*,<sup>18</sup> the Second Circuit wrestled with the level of “friendship” necessary to demonstrate a “benefit” to the tipper under *Dirks*. Picking up on the passage from *Dirks* quoted above, the Second Circuit wrote that, under *Dirks*, the personal benefit to the insider that is necessary to establish liability generally requires proof of “an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.”<sup>19</sup>

Applying this standard, the court held that “[t]he circumstantial evidence in this case was simply too thin to warrant the inference that the corporate insiders received any personal benefit in exchange for their tips.”<sup>20</sup> *Newman* rejected as insufficiently close a relationship where two individuals “had known each other for years, having both attended business school together and worked [together],” where the insider sought “career advice and assistance” from the tippee, and where the tippee edited the insider’s resume and sent it to a recruiter.<sup>21</sup> Similarly, the Second Circuit rejected as insufficiently close to show a benefit a relationship between two individuals who were “family friends,”

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<sup>11</sup> Roberta S. Karmel, *The Law on Insider Trading Lacks Needed Definition*, 68 SMU L. REV. 757, 757 (2015).

<sup>12</sup> 463 U.S. at 659-60.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 663.

<sup>15</sup> *Id.* at 664.

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<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> 773 F.3d 438 (2d Cir. 2014).

<sup>19</sup> *Id.* at 452.

<sup>20</sup> *Id.* at 451-52.

<sup>21</sup> *Id.* at 452.

having met through church and having “occasionally socialized together.”<sup>22</sup>

While presenting its analysis as a straightforward interpretation of *Dirks*, *Newman* arguably applied the principles set forth in *Dirks* somewhat more narrowly than the language of *Dirks* requires. In particular, *Dirks* allows for liability where a tipper gifts information to a “trading relative or friend” because “[t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.”<sup>23</sup> But the Second Circuit in *Newman* rejected the notion “that the Government may prove the receipt of a personal benefit by the mere fact of a friendship, particularly of a casual or social nature”<sup>24</sup> — a limit not explicitly present in *Dirks*.

### III. THE SECOND CIRCUIT’S EN BANC PRACTICE

A full understanding of *Newman*, as well as the insider trading opinions that followed from the Second Circuit, requires an understanding of how the Second Circuit, as an institution, approaches the question of when en banc review is appropriate.

Under the Federal Rules of Appellate Procedure, a petition for en banc review must begin with a statement that the decision at issue “conflicts with a decision of the United States Supreme Court or of the court to which the petition is addressed” such that “consideration by the full court is therefore necessary to secure and maintain uniformity of the court’s decisions; or [that] the proceeding involves one or more questions of exceptional importance.”<sup>25</sup>

In *Newman*, the government sought en banc review, arguing that each of these criteria was satisfied. The government argued that *Newman* “breaks with Supreme Court and Second Circuit precedent, conflicts with the decisions of other circuits, and threatens the effective enforcement of the securities laws.”<sup>26</sup> In other words, according to the government, *Newman* was precisely the kind of case for which en banc review is warranted.

But the Second Circuit — more so than any other circuit — generally does not grant petitions for rehearing en banc.<sup>27</sup> The Second Circuit “hears the fewest cases en banc of any circuit by a substantial margin, both in absolute terms and when considering the relative size of [its] docket.”<sup>28</sup> To justify this unique aspect of Second Circuit institutional practice, judges of the Second Circuit have consistently highlighted for many decades the degree to which avoiding en banc proceedings avoids the inefficiencies inherent in the process and helps to preserve collegiality among judges of the court.<sup>29</sup> In recent years, the Second Circuit has adhered to this practice even in cases of exceptional importance.

For example, in *Microsoft Corp. v. United States*,<sup>30</sup> a case relating to the extraterritorial application of United States law, the Second Circuit denied the government’s petition for rehearing en banc over the dissenting opinions of four members of the court.<sup>31</sup> Ultimately,

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<sup>22</sup> *Id.*

<sup>23</sup> *Dirks*, 463 U.S. at 664.

<sup>24</sup> *Newman*, 773 F.3d at 452.

<sup>25</sup> Fed. R. App. P. 35(b)(1).

<sup>26</sup> Petition of the United States of America for Rehearing and Rehearing En Banc at \*1, *Newman*, No. 13-1917(Con.), 2015 WL 1954058, 2015 WL 1064423 (2d Cir. Jan. 23, 2015).

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<sup>27</sup> See, e.g., Martin Flumenbaum & Brad S. Karp, *The Rarity of En Banc Review in the Second Circuit*, 250 N.Y.L.J. No. 38 (Aug. 24, 2016) (“Since 1979, the U.S. Court of Appeals for the Second Circuit has consistently granted fewer petitions for rehearing en banc than any other circuit court, both in absolute terms and relative to the court’s caseload.”); Steven M. Witzel & Samuel P. Groner, *Mini-En Banc Review In the Second Circuit*, 255 N.Y.L.J. No. 4 (Jan. 7, 2016).

<sup>28</sup> *United States v. Taylor*, 752 F.3d 254, 255 n.1 (2d Cir. 2014) (Cabranes, J., dissenting from the order denying rehearing en banc).

<sup>29</sup> See, e.g., Wilfred Feinberg, *The Office of Chief Judge of a Federal Court of Appeals*, 53 FORDHAM L. REV. 369, 376–77 (1984) (“The tradition in the Second Circuit, a tradition that goes back to Learned Hand, is that in bancs are not encouraged. My view, and that of my predecessor, Irving R. Kaufman, is that for the most part in bancs are not a good idea: They consume an enormous amount of time and often do little to clarify the law.”); James Oakes, *Personal Reflections on Learned Hand and the Second Circuit*, 47 STAN. L. REV. 387, 392–93 (1995) (“[T]he Second Circuit has avoided a practice which is enormously time-consuming and expensive, and which often yields a confusing multiplicity of opinions. In addition, I believe our en banc policy has helped us to maintain collegiality by avoiding the divisions that have caused friction on other courts of appeal.”); *but see Zhong v. U.S. Dep’t of Justice*, 489 F.3d 126, 139 (2d Cir. 2007) (Jacobs, C.J., dissenting from the denial of rehearing en banc) (calling the Second Circuit’s en banc practice “rusty and cumbersome”).

<sup>30</sup> 829 F.3d 197 (2d Cir. 2016), *vacated and remanded sub nom.*, *United States v. Microsoft Corp.*, 138 S. Ct. 1186 (2018).

<sup>31</sup> 855 F.3d 53 (2d Cir. 2017).

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however, the Supreme Court granted the government’s petition for certiorari in the case, which was resolved with a legislative fix before the Supreme Court could issue an opinion addressing the merits.<sup>32</sup> In the meantime, in advance of the legislative fix, the opinions of the four Second Circuit judges who dissented from the denial of en banc review were widely cited by lower courts that disagreed with the Second Circuit.<sup>33</sup> In short, if *Microsoft* — a case that was one of the select few to be accepted by the Supreme Court — did not qualify as sufficiently important for en banc review in the Second Circuit, it is difficult to imagine what case would.<sup>34</sup>

In keeping with this institutional practice, the Second Circuit denied the government’s petition for rehearing en banc in *Newman*,<sup>35</sup> notwithstanding the importance of the issues presented, and despite the arguable degree to which the panel’s opinion departed from *Dirks* and other precedent.

#### IV. SALMAN: THE SUPREME COURT’S NARROW REVIEW

The government filed a petition for certiorari in *Newman*, while at roughly the same time a defendant sought certiorari in a case out of the Ninth Circuit, *Salman v. United States*.<sup>36</sup> The Supreme Court declined

to review *Newman*, but agreed to review *Salman*, which was in some respects a simpler case.

There, defendant Bassam Salman received tips from Michael Kara. Michael Kara, in turn, received the confidential information from his brother Maher Kara, who had access to the information as part of his job at Citigroup. Maher Kara was also married to Salman’s sister, and it was through the family connection that Michael Kara and Salman became friends. At trial, both Kara brothers testified, providing evidence that they were close, that Maher shared information with Michael to benefit him, and that Maher expected Michael to trade on the information. The evidence further showed that Salman knew both that the tips he received from Michael came from Maher, and that the brothers were close.<sup>37</sup> Evidence emerged at trial that on one occasion when Michael asked Maher for a favor, Maher offered money, but his brother asked for confidential information he could trade on instead,<sup>38</sup> encapsulating *Dirks*’ formulation of a trade by an insider followed by a gift of the proceeds.

*Salman* thus presented a fact pattern so straightforward that Justice Samuel A. Alito began the discussion section of his opinion for the unanimous eight-justice Court with a one-sentence paragraph: “We adhere to *Dirks*, which easily resolves the narrow issue presented here.”<sup>39</sup> Justice Alito explained:

*Dirks* specifies 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. In such situations, the tipper benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds. Here, by disclosing confidential information as a gift to his brother with the expectation that he would trade on it, Maher breached his duty of trust and confidence to Citigroup and its clients — a duty Salman acquired, and breached himself, by trading on the information with full knowledge that it had been improperly disclosed.<sup>40</sup>

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<sup>32</sup> *Microsoft*, 138 S. Ct. 1186.

<sup>33</sup> See, e.g., *In re Info. associated with one Yahoo email address that is stored at premises controlled by Yahoo*, No. 17-M-1234, 2017 WL 706307, at \*3 (E.D. Wis. Feb. 21, 2017) (“The court finds persuasive the analysis of the four judges dissenting from the denial of en banc rehearing in *Microsoft*.”); *Matter of Search of Contents & records relating to Google Accounts*, 310 F. Supp. 3d 883, 887 (S.D. Ohio 2018) (observing that “[p]recisely half of the members of Second Circuit disagree with the panel decision in *Microsoft I*.”)

<sup>34</sup> At least one judge of the Second Circuit once expressed the view that “[o]ur rule of thumb has been that most cases are either too unimportant or too important to en banc; in other words, if a case is unimportant, it should not tax the resources of an entire court, and if it is important enough to warrant en banc review, then perhaps the Supreme Court should hear it.” Oakes, *supra* note 29, at 392. Applying that “rule of thumb,” perhaps the Second Circuit viewed the *Microsoft* case as too important for en banc proceedings and as a case that should go straight to the Supreme Court. Given the limited number of cases the Supreme Court hears, however, it is only in the rarest of cases that a court should bank on Supreme Court review.

<sup>35</sup> *United States v. Newman*, No. 13-1837(L), No. 13-1917(Con.), 2015 WL 1954058, at \*1 (2d Cir. Apr. 3, 2015).

<sup>36</sup> 137 S. Ct. 420, 424–25 (2016).

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<sup>37</sup> *Id.*

<sup>38</sup> *Id.* at 424.

<sup>39</sup> *Id.* at 427.

<sup>40</sup> *Id.* at 428.

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At this point, Justice Alito noted that “[t]o the extent the Second Circuit held that the tipper must also receive something of a ‘pecuniary or similarly valuable nature’ in exchange for a gift to family or friends [in *Newman*], we agree with the Ninth Circuit that this requirement is inconsistent with *Dirks*.”<sup>41</sup>

Justice Alito’s narrow opinion in *Salman* went no further than it needed to, in keeping with Chief Justice Roberts’s oft-expressed view that “[i]f it is not necessary to decide more, it is necessary not to decide more.”<sup>42</sup> Even so, some viewed *Salman* as “a missed opportunity for the Roberts Court to fine-tune and improve insider trading regulation.”<sup>43</sup>

Again, taking a broader view, it appears that the Supreme Court’s institutional preference for narrow decisions — per the Chief Justice’s observation — like the Second Circuit’s institutional preference not to go en banc, outweighed any benefit that could have been had from a somewhat broader opinion in this particular context.

## V. MARTOMA AND THE SECOND CIRCUIT’S DENIAL OF EN BANC

Post-*Salman*, a divided panel of the Second Circuit issued two separate opinions in *United States v. Martoma* — *Martoma I* and *II*.<sup>44</sup> By way of

background, defendant Mathew Martoma was convicted of insider trading charges at trial where the evidence showed that Martoma had some 43 consultations (some paid) with Dr. Sidney Gilman, the chair of a committee for a drug’s clinical trial, and Dr. Gilman disclosed test results for the drug to Martoma before they were public, enabling Martoma’s fund to trade and make approximately \$80 million in gains and \$195 million in averted losses. The government argued at trial that Dr. Gilman, the tipper, benefited both because he was paid for his consultations, and because he and Martoma were friends. On appeal, Martoma argued, among other things, that the jury instructions at his trial were inconsistent with the personal benefit rule articulated in *Newman*.

In *Martoma I*, which was decided after *Salman*, the majority rejected the defense argument, writing that “*Salman* fundamentally altered the analysis underlying *Newman*’s ‘meaningfully close personal relationship’ requirement such that the ‘meaningfully close personal relationship’ requirement is no longer good law.”<sup>45</sup> In place of this test, *Martoma I* held that a tipper “‘personally benefits from a disclosure of inside information whenever the information was disclosed ‘with the expectation that [the recipient] would trade on it,’ . . . and the disclosure ‘resemble[s] trading by the insider followed by a gift of the profits to the recipient, . . . whether or not there was a ‘meaningfully close personal relationship between the tipper and tippee.’”<sup>46</sup>

In dissent, Judge Rosemary Pooler wrote that the majority’s opinion in *Martoma I* not only failed to heed the limits of *Dirks* and *Salman*, but also effectively and impermissibly overruled *Newman* without going en banc.<sup>47</sup> Judge Pooler pointed out that the government pushed the majority’s theory that “a gift of confidential information to anyone, not just a ‘trading relative or friend,’ is enough to prove securities fraud” in *Salman*, despite the fact that, according to Judge Pooler, the Supreme Court had not adopted that standard.<sup>48</sup>

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<sup>41</sup> *Id.*

<sup>42</sup> See, e.g., *PDK Labs., Inc. v. Drug Enforcement Admin.*, 362 F.3d 786, 799 (D.C. Cir. 2004) (Roberts, *J.*, concurring in part and concurring in judgment) (“This is a sufficient ground for deciding this case, and the cardinal principle of judicial restraint — if it is not necessary to decide more, it is necessary not to decide more — counsels us to go no further.”).

<sup>43</sup> Eric C. Chaffee, *The Supreme Court as Museum Curator: Securities Regulation and the Roberts Court*, 67 CASE W. RES. L. REV. 847, 883–84, 877–78 (2017) (“In regard to the Roberts Court and its treatment of securities regulation, the better comparison is to a museum curator . . . As evidenced by the unrealized landmark opinions, the Court has been unwilling to expand or contract the current scope of federal securities law.”).

<sup>44</sup> *United States v. Martoma*, 869 F.3d 58 (2d Cir. 2017) (*Martoma I*), opinion amended and superseded by 894 F.3d 64 (2d Cir. 2018) (*Martoma II*). As noted, the author previously served as Deputy Chief of Appeals at the U.S. Attorney’s Office for the Southern District of New York. In that capacity, and prior to the decision in *Salman* and the litigation that followed, he supervised the government’s briefing and oral argument in opposition to Martoma’s initial and successful

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request, following his conviction, that the Second Circuit grant him bail pending appeal.

<sup>45</sup> *Id.* at 69.

<sup>46</sup> *Id.* at 70 (alterations in original) (emphasis added) (citations omitted).

<sup>47</sup> *Id.* at 74 (Pooler, *J.*, dissenting).

<sup>48</sup> *Id.* at 86–87 (Pooler, *J.*, dissenting) (quoting *Salman*, 137 S. Ct. at 426) (internal quotation marks omitted).

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After *Martoma I*, Martoma filed a petition for rehearing, arguing that *Salman* did not discuss, let alone overrule *Newman*, and that the *Martoma I* holding in this regard was error. Nine months after Martoma filed that petition, on June 25, 2018, the same panel issued *Martoma II*, an amended opinion revising the original, with Judge Pooler still in dissent.<sup>49</sup> In the amended opinion, rather than disavowing *Newman*, the majority wrote that “because there are many ways to establish a personal benefit, we conclude that we need not decide whether *Newman*’s gloss on the gift theory is inconsistent with *Salman*.”<sup>50</sup>

To reconcile *Newman* with *Salman*, *Martoma II* went back to the text of *Newman*, explaining that “[i]mmediately after introducing the ‘meaningfully close personal relationship’ concept, *Newman* held that it ‘requires evidence of “a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter].”’<sup>51</sup> *Martoma II* read this sentence to “cabin[] the gift theory using two *other* freestanding personal benefits that have long been recognized by our case law” — that is, by *Dirks* itself.<sup>52</sup> Thus, under *Martoma II*, the personal benefit requirement may be satisfied if the tipper and tippee had a *quid pro quo* relationship<sup>53</sup> or if the tipper conveyed inside information with the purpose of benefiting the recipient.

Following *Martoma II*, Martoma petitioned for rehearing en banc, writing:

The panel’s amended decision marks the third time during this appeal that a panel of this Court has addressed the personal benefit test in depth — twice in this case itself (and both times over vigorous dissent). This is plainly an issue on which members of this Court are divided, and it is plainly an issue of surpassing importance, particularly in this Circuit, where the majority of insider trading cases are brought. Indeed, the Supreme Court itself

took up the personal benefit test just two years ago, underscoring its importance not just to this case, but to insider trading law throughout the nation. A decision that breaks so sharply with Circuit and Supreme Court precedent should not be allowed to become the law of the Second Circuit without consideration by the full Court.<sup>54</sup>

On August 27, 2018, the Second Circuit denied Martoma’s petition for en banc review, noting that no active member called for an en banc poll.<sup>55</sup>

As noted, judges of the Second Circuit have consistently disfavored en banc proceedings due to their inefficiency and their threat to collegiality.<sup>56</sup> It is possible to read *Martoma II* as a successful effort by the Second Circuit to further these important goals: by issuing an amended opinion, the panel was able to preclude an inefficient and drawn-out en banc process, and perhaps maintained collegiality and harmony among judges by harmonizing (or at least trying to harmonize) *Dirks*, *Newman*, *Salman*, and *Martoma I*. So too was this goal of collegiality arguably furthered at the Supreme Court by Justice Alito’s narrow but unanimous decision in *Salman*.

But collegiality here may well have come at the cost of clarity — clarity that is important for market participants on a daily basis, and for prosecutors and defense counsel as they wrestle with insider trading investigations.<sup>57</sup> As *Martoma II* attempted to draw a clean line from *Dirks*, to *Newman*, *Salman*, and *Martoma*, the decision ultimately reduced the underpinnings of the case law back down to the language of *Dirks* itself. But *Dirks* was just one case; *Dirks* is not a statute. *Dirks* itself acknowledges the need for future case law, saying that “[d]etermining

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<sup>49</sup> *Martoma II*, 894 F.3d 64.

<sup>50</sup> *Id.* at 71.

<sup>51</sup> *Id.* (second alteration in original) (quoting *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013) (quoting *Dirks*, 463 U.S. at 664)).

<sup>52</sup> *Id.*

<sup>53</sup> A “quid pro quo” in this context generally refers to cases where the tippee pays the insider for tips, or where the tippee provides some other form of compensation, such as goods or services.

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<sup>54</sup> Petition for Rehearing En Banc at 2–3, *United States v. Martoma*, No. 14-3599 (2d Cir. Aug. 8, 2018), ECF No. 239.

<sup>55</sup> Order, *United States v. Martoma*, No. 14-3599 (2d Cir. Aug. 27, 2018), ECF No. 254.

<sup>56</sup> See *supra* note 29.

<sup>57</sup> It is of course possible that an en banc proceeding could have produced no greater clarity than the panel opinions themselves. But there is no reason to say that this necessarily would have been the result. In the *Microsoft* case described above, for example, the Second Circuit did not go en banc and four judges wrote individual opinions dissenting from that vote. But even those dissenting opinions helped to clarify the law and were widely followed in lower courts (outside the Second Circuit) before Congress stepped in with a legislative fix.

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whether an insider personally benefits from a particular disclosure, a question of fact, *will not always be easy for courts*.<sup>58</sup> More than three decades later, though, in *Salman*, rather than elaborating on *Dirks*, the Supreme Court instead observed that “there is *no need* for us to address those difficult cases today, because *this* case involves precisely the gift of confidential information to a trading relative that *Dirks* envisioned.”<sup>59</sup> Left essentially unsaid is the fact that the Supreme Court denied the petition for certiorari in one such difficult case — *Newman*. And also left unsaid is the fact that contrary to the implicit promise of *Dirks* and *Salman* — that future case law will limn the precise contours of insider trading law — the reality is that the institutional dynamics at both the Supreme Court and the Second Circuit may well prevent this from ever happening.

## VI. AMBIGUITIES IN THE WAKE OF *MARTOMA II* AND POSSIBLE RESOLUTIONS

By upholding *Newman*, while at the same time holding that *Newman*’s “meaningfully close personal relationship” test can be met by a showing of a tipper’s “intention to benefit” the tippee, *Martoma II* creates a problematic ambiguity that will manifest itself in two particular kinds of cases.

First, the most difficult cases after *Martoma II* may be those where the tipper and tippee do not share any “meaningfully close personal relationship,” as *Newman* requires, and yet the government is able to demonstrate that the tipper had the “intention to benefit” the tippee. (For instance, imagine the example, discussed in *Martoma I*, of a building tenant giving a doorman inside information in lieu of a holiday tip.) On the one hand, under *Martoma II*, such proof of intention to benefit would arguably be sufficient, to the extent *Martoma II* treats the tipper’s “intention to benefit” the tippee as evidence of the requisite relationship from which the jury can infer that the tipper received a personal benefit by providing the tip.<sup>60</sup> On the other hand, defense

counsel may argue that the government still must demonstrate, in addition to an “intention to benefit,” that the tipper and tippee had a “meaningfully close personal relationship,” per *Newman*. After all, *Martoma II* itself treats *Newman* as good law, and the panel had no power to overrule it.

A second category of difficult cases after *Martoma II* may be those where the tipper and tippee do in fact share a “meaningfully close personal relationship,” but there is no evidence other than the relationship itself that the tipper intended to benefit the tippee. (For instance, imagine the example of two former college roommates who work for rival firms and who remain close, one of whom is a compulsive gossip and shares inside information with the roommate without having any intention to benefit the roommate.) In such cases, the government may seek to revert to the concept in *Newman* and *Dirks* that a tipper’s personal benefit can be inferred from the closeness of a relationship between the tipper and tippee, without the need for an additional showing of an “intention to benefit.” *Martoma II* makes some effort to foreclose this argument, with the majority writing that a jury can only find a personal benefit based on friendship if the jury also finds a *quid pro quo* or the tipper’s intention to benefit the tippee. But that holding would seem to cut out from the reach of insider trading law a whole category of cases that would arguably have been prosecutable under *Dirks* — something the *Martoma II* panel again had no power to do.

Although *Martoma II* does not resolve these ambiguities, the institutional dynamics that created them point to how they might be resolved. In seeking en banc review, *Martoma* argued that “the panel majority adopts its ‘intention to benefit’ standard only by abrogating *Newman* and disregarding *Dirks* . . . steps it had no power to take.”<sup>61</sup> But precisely because the Second Circuit lacked the power to abrogate *Newman* and disregard *Dirks*, district courts may follow *Newman* and *Dirks*, as well as *Martoma II*. Just as the Second Circuit avoided en banc review by attempting to harmonize these precedents, district courts too could try to incorporate all three decisions into jury instructions, taking the Second Circuit at its word that *Newman* remains binding authority (aside from the extent to which *Salman* overruled it, noted above).

Thus, for example, district courts could require that the government show *both* the tipper’s intention to benefit the tippee (per *Martoma II*) and that the tipper

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<sup>58</sup> *Dirks*, 463 U.S. at 664 (emphasis added).

<sup>59</sup> *Salman*, 137 S. Ct. at 429 (emphasis added) (internal quotation marks omitted).

<sup>60</sup> In dissent in *Martoma II*, Judge Pooler criticized the logic underpinning the notion that proof of a tipper’s “intention to benefit” the tippee can show a benefit to a tipper: “Intending to benefit somebody is not in itself a benefit. That is, not unless one has reason to believe that the person with the intention to benefit benefits from the beneficiary’s benefit or one adopts the trivializing view of human psychology wherein everything any individual does is to benefit herself.” *Martoma II*, 894 F.3d at 85 (Pooler, *J.*, dissenting).

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<sup>61</sup> Petition for Rehearing En Banc at 14, *United States v. Martoma*, No. 14-3599 (2d Cir. Aug. 8, 2018), ECF No. 239 (other internal quotation marks and alterations omitted).

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and tippee shared a meaningfully close personal relationship (per *Newman*). Both concepts could be incorporated into a jury charge. The government may resist such a charge on the ground that *Martoma II* re-articulated *Newman*'s "close relationship" requirement, essentially replacing it with the "intention to benefit" standard, but given that only an en banc court can overrule the decision of a prior panel, this argument may not carry the day. A jury charge could also thread the needle here by linking the two concepts and instructing the jury, for example, that it must find "a meaningfully close personal relationship, *which exists* where there is an intention by the tipper to benefit the tippee."

If the law develops in this way — and no court has yet addressed the issue in a reported decision — the ability of the government to bring cases could be doubly limited: once by *Newman*, and then again by *Martoma II*'s gloss on *Newman*.

## VII. WHAT COMES NEXT?

In the absence of a legislative fix from Congress or clarification from the SEC,<sup>62</sup> and in the absence of case law clarifying the line between legal and illegal insider trading under Title 15 of the United States Code (regarding the securities markets specifically), prosecutors have begun to turn back to Title 18 (which addresses criminal prohibitions more broadly).

The recent verdict in the criminal prosecution of David Blaszcak for insider trading is instructive.<sup>63</sup> Blaszcak, along with other more remote tippees, was acquitted of insider trading on counts alleging violations of Rule 10b-5. On the same factual basis, however, Blaszcak and others were convicted of insider trading in violation of Title 18, United States Code, Section 1348, which broadly prohibits securities fraud. The key case underlying the Title 18 theory is *Carpenter v.*

*United States*,<sup>64</sup> a case decided by the Supreme Court a few years after *Dirks*, which holds that a conspiracy to trade on a newspaper's confidential information was encompassed by the mail and wire fraud statutes.

The disparate verdicts in *Blaszcak* may well stem from "stark differences in the elements of criminal liability under Rule 10b-5 and Section 1348."<sup>65</sup> For the Title 18 charge, the government did not have to prove "a tipper's breach of a fiduciary duty, personal benefit to the tipper and tippee knowledge of a breach of confidentiality and receipt of personal benefit."<sup>66</sup> *Blaszcak* thus not only reflects, but may in fact promote the absence of further case law on the personal benefit requirement, and may cause prosecutors to avoid thorny insider trading issues by pursuing charges under Title 18 instead.

If prosecutors do turn to Title 18 and *Carpenter*, the ironic outcome may well be the parsing of *Carpenter*'s language, just as courts have parsed *Dirks*' language. And will institutional dynamics affect interpretations of *Carpenter*? Time will tell. Unlike with Title 15, though, *Carpenter* is based on a relatively clear governing statute with a more developed body of precedent, so courts may end up looking at interpretations of Sections 1341 and 1343, the bank and wire fraud statutes (which share language with Section 1348, covering securities fraud).

But based on past practice, it is also entirely possible that appellate courts will return to the precise language of *Carpenter* to see whether the activity charged is encompassed there, but will avoid going further. Just as importantly, the lack of clarity at the appellate level will likely place greater pressure on district courts to draw lines between legal and illegal conduct, and to offer clearer guidance to market participants and counsel than what the appellate decisions in this area provide. ■

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<sup>62</sup> On October 9, 2018, in an effort to spur Congress or the SEC to action, former U.S. Attorney Preet Bharara and SEC Commissioner Robert J. Jackson Jr. announced the creation of a task force comprised of "eight distinguished former regulators and prosecutors, judges, academics, and defense lawyers" that "will propose new insider trading reforms to protect American investors." Preet Bharara & Robert J. Jackson Jr., *Insider Trading Laws Haven't Kept Up With the Crooks*, N.Y. Times (October 9, 2018) (observing that "[t]he shoddy state of American insider-trading law affects everyone").

<sup>63</sup> *United States v. Blaszcak*, 17 Cr. 357 (S.D.N.Y. 2018).

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<sup>64</sup> 484 U.S. 19 (1987).

<sup>65</sup> Elkan Abramowitz & Jonathan S. Sack, *Back to the Future: Criminal Insider Trading Under Title 18*, 260 N.Y.L.J. No. 2 (July 3, 2018).

<sup>66</sup> *Id.* at \*2.

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**CLE QUESTIONS** on Jacobs, *How Institutional Dynamics Have Shaped Insider Trading Law*. Circle the correct answer to each of the questions below. If at least four questions are answered correctly, there is one credit for New York lawyers (nontransitional) for this article. Complete the affirmation, evaluation, and type of credit, and return it by e-mail attachment to rscrpubs@yahoo.com. The cost is \$40, which will be billed to your firm. To request financial aid, contact us by e-mail or fax, as provided above.

1. In *Dirks*, the Supreme Court wrote that an insider's gift of confidential information to a "trading relative or friend" could be a breach of duty by the tipper that would make the tippee liable if he traded on it. The Court did not define the level of friendship that would be sufficient to constitute a benefit to the tipper for these purposes. **True** **False**

2. In *Newman*, the Second Circuit rejected the notion that the government may prove the receipt of a personal benefit to the tipper merely from the fact of a friendship with the tippee, particularly of a casual or social nature, and dismissed the case. The government sought en banc review, which was granted, and the en banc court affirmed the panel's decision. **True** **False**

3. In *Salman*, the tippee, Salman, who traded, had tips from Michael Kara who in turn received information from his brother, the tipper. In affirming Salman's conviction, the Supreme Court noted that Newman's holding that the tipper must receive something of a "pecuniary or similarly valuable nature" in exchange for confidential information was inconsistent with *Dirks*. **True** **False**

4. In *Martoma*, the Second Circuit held, in a revised opinion, that Newman's personal benefit gift theory required evidence of a relationship between the insider and the tippee that suggested a *quid pro quo* from the tippee or the tipper's intention to benefit the tippee. **True** **False**

5. In *Carpenter*, decided a few years after *Dirks*, the Supreme Court held that a conspiracy to trade on a newspaper's confidential information was not a violation of Title 18 mail and wire fraud statutes. **True** **False**

### AFFIRMATION

\_\_\_\_\_, Esq., an attorney at law, affirms pursuant to CPLR

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2106 and under penalty of perjury that I have read the above article and have answered the above questions without the assistance of any person.

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