The HEDGE FUND LAW REPORT

The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Vol. 11, No. 35 September 6, 2018

INSIDER TRADING

Although *Martoma* May Have Been Put to Rest, the Debate Over the "Personal Benefit" Test Continues

By Justin V. Shur and Emily Damrau, MoloLamken LLP

Several recent high-profile insider trading cases have ignited a debate over what is necessary to satisfy the "personal benefit" requirement for purposes of tipper-tippee liability. The saga began in 2009, when the government commenced its long-running probe into the alleged sharing of confidential information on publicly traded companies with hedge fund managers and analysts. With the recent announcement that the Second Circuit will not grant an en banc rehearing of the appeal of former SAC Capital employee Mathew Martoma's conviction, that story appears to be coming to a close.

The debate over the personal benefit test and the scope of tipper-tippee liability is sure to persist, however. *U.S. v. Martoma* left no clear consensus on the requisite standard. Instead of providing much-needed guidance in a murky area of the law, the Second Circuit added to a group of recent decisions that have generated confusion for market participants over the line that delineates illegal insider trading from legal trading on proprietary information. This uncertainty and the continued debate over the contours of insider trading liability underscore the need for funds to be vigilant in this area.

This article analyzes the personal benefit test and offers guidance on what fund managers can do to avoid liability.

For recent insider trading enforcement actions against hedge funds, see "Hedge Fund Manager Deerfield Fined $4.7 Million for Failing to Adopt Insider Trading Compliance Policies Tailored to the Firm's Specific Risks" (Sep. 21, 2017); and "SEC Insider Trading Action Highlights Red Flags Hedge Fund Managers Must Heed When Employing Political Intelligence Consultants" (Jun. 8, 2017).

The Personal Benefit Test

Trading on material nonpublic information (MNPI) is illegal only if it involves a breach of a fiduciary duty. A classic example is the corporate insider who trades on inside information obtained by reason of his or her position and thus breaches his or her fiduciary duty to the company and its shareholders.

Insider trading cases, however, often involve "tipping" – *i.e.,* where an insider who obtains MNPI (the tipper) does not trade on it but rather provides the information to a non-insider who does (the tippee). The tippee may not have any fiduciary duty to the company or its shareholders but can still be liable for insider trading based on a breach of the insider's duty.

In deciding what constitutes a breach in the tipper-tippee context, the U.S. Supreme Court created the "personal benefit" test. The Court, in *Dirks v. SEC*, held that whether an insider breached a fiduciary duty for purposes of tipper-tippee liability hinges on whether the tipper personally benefitted, directly or indirectly, from his or her disclosure of the information. The personal benefit to the insider can be pecuniary or reputational. The Court also found that a tip that represents "a gift of confidential information to a trading relative or friend" is sufficient.

The personal benefit test provided a framework for analyzing future tipper-tippee cases. The Court rightly recognized, however, that applying it "will not always be easy for the courts."

A Standard in Flux

In the last few years, courts have provided additional but, at times, inconsistent guidance on what is needed to satisfy the personal benefit test. In 2014, the Second Circuit, in *U.S. v. Newman*, provided a new gloss on the requirement. The court held that a gift of confidential information only amounts to a personal benefit when the tipper had a "meaningfully close personal relationship" with the tippee and the tipper received something that represented "at least a potential gain of a pecuniary or similarly valuable nature."

For more on *Newman*, see "The *Newman-Chiasson* Decision: Cold Comfort for Hedge Fund Managers" (Dec. 18, 2014).

Then, in 2016, the Supreme Court decided *Salman v. U.S.*, rolling back one of the additional requirements imposed by *Newman*. The Court found that an insider who gifts information to a trading relative or friend receives the requisite

©2018 The Hedge Fund Law Report. All rights reserved.

personal benefit without anything more. The Court stated that the Second Circuit's requirement that "the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends . . . is inconsistent with *Dirks*" and is therefore abrogated. The Court, however, did not explicitly address the "meaningfully close personal relationship" requirement articulated in *Newman*.

For more on *Salman*, see "Supreme Court's Ruling in *Salman v. U.S.* Affirms the Importance of a Tipper's 'Personal Benefit' for Insider Trading, but Also Creates Uncertainty" (Feb. 9, 2017).

In *Martoma*, the Second Circuit held that, after *Salman*, the requirement of a meaningfully close personal relationship was "no longer good law." A year later, in a revised opinion, the Second Circuit reversed course. The court held that "[b]ecause 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.*" The court further held that even under *Newman*, the personal benefit test is met when a tipper gifts inside information with the "intention to benefit" the tippee.

After all these cases, the personal benefit requirement is still imprecise. Moreover, if and when a "meaningfully close personal relationship" between the tipper and the tippee is required to establish liability is unclear. One thing is certain, however: without a clearly defined standard for liability, litigation in this area will not cease.

For more on insider trading liability post-*Martoma*, see "HFLR Panel Identifies Best Practices for Avoiding Insider Trading Liability in the Aftermath of *Martoma*" (Jan. 18, 2018).

Implications for Funds

Any time a fund receives information from a third party, there is always a risk that the information could be MNPI and thus expose the fund to potential liability as a tippee. Given the ongoing debate over what triggers tippee liability, funds should be vigilant in this area. That means revisiting the insider trading risks unique to their businesses and reevaluating their policies to ensure they are taking reasonable steps to avoid or minimize exposure to liability.

At a minimum, funds should undertake the following.

Establish and Enforce Clear Insider Trading Policies and Controls

A fund should establish and enforce formal written policies that demonstrate its commitment to comply with insider trading laws. These policies should be clear, concise and accessible to all employees.

Insider trading policies and procedures should, at a minimum:

- make clear to employees what trading is and is not permitted;
- warn employees about the consequences of violating the policy; and
- provide a contact person who can assist employees who are uncertain about what they may and may not do.

In addition to adopting a clearly articulated policy against all forms of insider trading, funds should institute meaningful insider trading controls, auditing practices and documentation policies with the goal of preventing and detecting misconduct. Funds, for example, should consider monitoring and restricting employee trading based on need and risk, including placing limits on who can trade; what sort of securities can and cannot be traded; and when trading may or may not be appropriate.

See "Will Inadequate Policies and Procedures Be the Next Major Focus for SEC Enforcement Actions?" (Nov. 30, 2017).

Conduct Specialized Training

Employees need to know what the rules are, know how to identify warning signs and know whom to go to when there is a problem. An effective, ongoing education and training program for employees is essential to any insider trading compliance program.

Periodic training sessions should cover:

- a discussion of insider trading law and all other relevant regulations;
- the fund's insider trading compliance policies and controls;
- areas of insider trading risk specific to the fund; and
- ways to identify and prevent problems in those areas, as well as practical advice to address real-life scenarios.

©2018 The Hedge Fund Law Report. All rights reserved.

Attendance at training sessions should be mandatory, and funds should document their efforts by retaining training materials and requiring employees to sign certificates of completion.

See "High- and Low-Tech Innovations for Fund Managers to Overcome Compliance Training's Drawbacks" (Feb. 1, 2018).

Monitor the Use of Third-Party Consultants

Funds that retain third-party consultants or that wish to do so should establish rules and procedures to minimize insider trading risk. Below are a few suggestions.

- The fund should perform due diligence by, among other things, reviewing the third-party consultant's compliance policies to assess how the consultant addresses insider trading risks and how it enforces those policies.
- Any contract with a third-party consultant should carefully spell out prohibited behavior and require the consultant to indemnify the fund in the event of any violations.
- The fund should ensure that its own compliance policies and controls address the risks associated with the use of third-party consultants. To identify and prevent problems, funds can use a variety of methods, from documenting conversations with the consultant in which the fund employee verifies that the consultant is complying with applicable laws to ensuring that appropriate trading restrictions are put in place if it is suspected that a third party has provided prohibited inside information.
- Fund employees should be trained on the permissible limits of using the third-party consultant and how to identify and avoid potential problems.

Remain Vigilant and React Quickly

These compliance measures, among others, can mitigate the likelihood of insider trading issues arising and can be critical in defending a fund against an enforcement inquiry. Even with these measures in place, however, it is important for funds to remain alert in identifying and investigating possible signs of insider trading. If, at any point, the fund learns of a potential insider trading violation by an employee, the firm should undertake an appropriate inquiry and, if necessary, take remedial action.

If a violation does occur, enforcement authorities will consider a fund's history of finding and fixing problems when deciding what, if any, action is appropriate. Thus, the fund's response to any potential insider trading incident should be well-documented and should establish whether the problem is unique to a single employee or trade or whether a broader investigation is needed. It is also crucial to ensure that any remedial efforts – whether punishment of employees, revising company policies or cooperation with authorities – are consistent with fund policy and, as needed, the advice of counsel.

See our three-part series on employee discipline: "Developing an Employee Discipline Framework That Fosters Predictability in the Face of Inconsistent Laws" (Feb. 8, 2018); "Investigating and Documenting Employee Discipline" (Feb. 15, 2018); and "Ensuring a Fair Process When Disciplining Employees" (Feb. 22, 2018).

While insider trading law continues to evolve, by taking reasonable steps to prevent, detect and remediate problems, a fund can effectively manage risks, assist its employees and protect its business.

Justin V. Shur is a former federal prosecutor and partner at MoloLamken LLP. Mr. Shur specializes in conducting corporate internal investigations and representing individuals and companies in government enforcement matters. He has a particular expertise in international criminal matters and counsels private funds, among other clients, facing difficult Foreign Corrupt Practices Act issues in a variety of business contexts.

Emily Damrau is an associate at MoloLamken LLP. Ms. Damrau's practice focuses on complex civil litigation, white collar matters and appellate litigation.

©2018 The Hedge Fund Law Report. All rights reserved.