

# A Friend in Need May Get You in Trouble for Insider Trading Indeed: An Argument for the Meaningfully Close Personal Relationship Definition of Friendship Under the Gift Theory

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*He that is thy friend indeed,  
He will help thee in thy need:  
If thou sorrow, he will weep;  
If thou wake, he cannot sleep;  
Thus of every grief in heart  
He with thee doth bear a part<sup>1</sup>*

## INTRODUCTION

Defining the types of relationships that qualify as true “friendships” is a surprisingly difficult task, particularly because people use the term colloquially to refer to multiple types of relationships. For instance, many people refer to their Facebook friends as “friends,” but a 2016 study conducted by Robin Dunbar, a professor of psychology at Oxford University, found that the vast majority of an individual’s Facebook friends are not that person’s “genuine” friends—“close friends” or people on whom the individual “would depend for emotional/social support in times of crisis.”<sup>2</sup> The difficulty in defining friendship is not just felt by individuals and academics; courts have also struggled to agree on a universal definition of the term in the tipper-tippe context of insider trading law. The Second Circuit has twice attempted to expressly define the term: once in December 2014 and once in August 2017.<sup>3</sup> In its most

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<sup>1</sup> Richard Barnfield, *An Ode: “As it Fell Upon a Day,”* in 1 THE ENGLISH POETS (Thomas Humphry Ward ed., Bartleby.com 2013) <http://www.bartleby.com/337/194.html> [<https://perma.cc/5HAL-CQT9>].

<sup>2</sup> R. I. M. Dunbar, *Do Online Social Media Cut Through the Constraints That Limit the Size of Offline Social Networks?*, ROYAL SOCIETY OPEN SCIENCE (Jan. 20, 2016) <http://rsos.royalsocietypublishing.org/content/3/1/150292> [<https://perma.cc/HZ3G-SFT5>] (finding that on average, out of 155.2 of an individual’s total Facebook “friends,” only 4.1 are “friends on whom [an individual] would depend for emotional/social support” and only 13.6 are considered an individual’s “close friends”).

<sup>3</sup> See *infra* Part I. Compare *United States v. Martoma*, 869 F.3d 58 (2d Cir. 2017), with *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), *abrogated by* *Salman v. United States*, 137 S. Ct. 420 (2016).

recent attempt, the Second Circuit created a new definition of friendship that dramatically departs from the definition the Second Circuit previously used in 2014. Thus, the time is ripe to consider the proper definition of friendship under insider trading law; specifically, which of the Second Circuit's two definitions is the appropriate definition of friendship.

In *Chiarella v. United States*, the Supreme Court held that Rule 10b-5, promulgated under Section 10(b) of the Securities Exchange Act of 1934, prohibits insider trading.<sup>4</sup> Tippees may be held liable for insider trading in violation of Rule 10b-5 when several elements are present, including proof that the tipper violated the trust and confidence—for example, a fiduciary duty—owed to the source of the inside information<sup>5</sup> by disclosing material, nonpublic, confidential information to the tippee.<sup>6</sup> In the seminal case *Dirks v. SEC*, the Court explained that an insider breaches his or her fiduciary duty by “using undisclosed corporate information to their advantage” or providing it to an outsider “for the same improper purpose of exploiting the information for their personal gain.”<sup>7</sup> The test for determining whether a tipper has disclosed information for an improper purpose is whether the tipper received a direct or indirect personal benefit from the disclosure (the “personal benefit requirement”).<sup>8</sup> *Dirks* described several theories under which a jury may infer that the tipper received a personal benefit,<sup>9</sup> including where an insider makes “a gift of confidential information to a trading relative or friend” (the “gift theory”).<sup>10</sup>

*Dirks* did not explicitly define the level of closeness that must exist between a tipper and tippee for the parties to be deemed “friends” under

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<sup>4</sup> See 17 C.F.R. § 240.10b-5 (2017); 445 U.S. 222, 226–35 (1980).

<sup>5</sup> Under both the classical and misappropriation theories of insider trading, courts look to whether a tipper's disclosure violated a duty of trust and confidence that the tipper owed to the source of the information. See *United States v. O'Hagan*, 521 U.S. 642, 651–52 (1997); *Chiarella*, 445 U.S. at 228. Under the classical theory of insider trading, this test is specifically framed as whether the insider breached his fiduciary duty to shareholders. See *Dirks v. SEC*, 463 U.S. 646, 660 (1983). The differences between the classical and misappropriation theories do not directly bear upon the focus of this paper; accordingly, this paper will not further address the differences.

<sup>6</sup> *Dirks*, 463 U.S. at 659–62.

<sup>7</sup> *Id.* at 659.

<sup>8</sup> See *id.* at 662. The ongoing debate as to whether the personal benefit requirement only applies to insider trading cases prosecuted under the classical theory but not under the misappropriation theory is beyond the scope of this Note. The Second Circuit applied the personal benefit test in *United States v. Martoma*, a tippee liability case prosecuted under the misappropriation theory. See 869 F.3d at 66–67.

<sup>9</sup> See *infra* note 78 and accompanying text.

<sup>10</sup> *Dirks*, 463 U.S. at 664.

the gift theory. The term went undefined until 2014, when the Second Circuit, in *United States v. Newman*, held that to justify the inference that a tipper gained a personal benefit under the gift theory, a tipper and tippee must: (1) have a “meaningfully close personal relationship” that (2) “generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.”<sup>11</sup> The Supreme Court subsequently abrogated the second part of *Newman*’s holding in *Salman v. United States*, providing: “[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 . . . this requirement is inconsistent with *Dirks*.”<sup>12</sup> *Salman*, however, did not directly discuss *Newman*’s “meaningfully close personal relationship” standard (the “close standard”). Surprisingly, after *Salman*, in *United States v. Martoma*, the Second Circuit overhauled the close standard and, in its place, instated a significantly different standard: a tipper personally benefits from gifting inside information to a tippee whenever the tipper does so “with the expectation that [the recipient] would trade on it.”<sup>13</sup>

This Note posits that *Newman*’s close standard is the correct definition of friendship. The paper is divided into two parts. Part I addresses the antecedent issue of whether *Salman* rejected the close standard, concluding that *Salman* neither expressly nor impliedly rejected the close standard. Part II establishes that prior cases and the underlying policy rationale of the prohibition against insider trading compel the conclusion that the close standard is the proper definition of friendship under the gift theory.

### I. THE CLOSE STANDARD AFTER *SALMAN*

The Second Circuit created the close standard in *Newman*, “seeking to give definition to the ‘friend’ language from *Dirks*.”<sup>14</sup> But, after *Salman*, the Second Circuit in *Martoma* held that the close standard “is no longer good law.”<sup>15</sup> In place of the close standard, *Martoma* proposed the following two-pronged standard (the “*Martoma* standard”) to use in the gift theory analysis: a tipper personally benefits from a disclosure of inside information whenever (1) “the disclosure resembles trading by the insider followed by a gift of the profits to the recipient” and (2) “the information was disclosed with the expectation that [the recipient] would trade on it.”<sup>16</sup>

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<sup>11</sup> 773 F.3d 438, 452 (2d Cir. 2014).

<sup>12</sup> 137 S. Ct. 420, 428 (2016).

<sup>13</sup> 869 F.3d 58, 70 (2d Cir. 2017) (quoting *Salman*, 137 S. Ct. at 428).

<sup>14</sup> *Martoma*, 869 F.3d at 68.

<sup>15</sup> *Id.* at 69.

<sup>16</sup> *Id.* at 70, 82 (internal quotation marks omitted) (quoting *Salman*, 137 S. Ct. at 428).

The Second Circuit emphasized that the *Martoma* standard “reject[s] . . . the categorical rule that an insider can *never* personally benefit from disclosing inside information as a gift without a ‘meaningfully close personal relationship.’”<sup>17</sup> As a preliminary note, this paper does not dispute *Martoma*’s holding insofar as *Martoma* held that there are circumstances where a tipper can personally benefit from gifting information to someone to whom he is not close. *Dirks* created, and *Salman* affirmed, an *inference* of personal benefit when a tipper gifts inside information “to a trading relative or friend.”<sup>18</sup> Accordingly, a tipper could personally benefit from gifting information to many types of tippees, but the gift theory does not support an inference of a personal benefit unless the tipper and tippee had a close relationship.

Part I of this Note challenges *Martoma*’s rejection of the close standard. In section A, this Note establishes that *Salman* did not expressly overrule the close standard. In section B, this Note specifically demonstrates that the underlying logic of *Salman* did not impliedly reject the close standard because both prongs of the *Martoma* standard are inconsistent with *Dirks* and *Salman*.

#### A. *SALMAN* DID NOT EXPRESSLY OVERRULE THE CLOSE STANDARD

As *Martoma* openly recognized, *Salman* did not expressly address *Newman*’s proposition that tipplers and tippees must have a meaningfully close personal relationship to justify the inference of personal benefit under the gift theory.<sup>19</sup> Indeed, *Salman* only expressly abrogated *Newman*’s second requirement that a tipper receive a gain of a “‘pecuniary or similarly valuable nature’ in exchange for a gift to family or friends.”<sup>20</sup> Moreover, *Salman* did not have occasion to address the requisite closeness of a tipper-tippee relationship to constitute a friendship under the gift theory because the tipper and tippee in *Salman* were brothers.<sup>21</sup>

To the extent that *Salman* indirectly addressed the close standard, it did so approvingly. Although *Salman* involved a tipper and tippee (Maher and Michael) who were brothers, the Court still went to lengths to

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<sup>17</sup> *Martoma*, 869 F.3d at 71.

<sup>18</sup> *Salman*, 137 S. Ct. at 423 (quoting *Dirks v. SEC*, 463 U.S. 646, 664 (1983)).

<sup>19</sup> See *Martoma*, 869 F.3d at 69 (“[T]he Supreme Court did not have occasion to expressly overrule *Newman*’s requirement that the tipper have a ‘meaningfully close personal relationship’ with a tippee to justify the inference that a tipper received a personal benefit from his gift of inside information—because that aspect of *Newman* was not at issue in *Salman* . . .”).

<sup>20</sup> *Salman*, 137 S. Ct. at 428 (quoting *United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014)).

<sup>21</sup> See *Salman*, 137 S. Ct. at 427; *Martoma*, 869 F.3d at 69.

establish that the brothers had a close relationship, stating that “[t]he evidence at trial established that Maher and Michael enjoyed a ‘very close relationship.’”<sup>22</sup> The Court described this close relationship as follows: Maher “relied on Michael’s chemistry background to help him grasp scientific concepts relevant to his new job”; the brothers helped one another search for “companies that dealt with innovative cancer treatment” for their father who “was battling cancer”; and “Michael was the best man at Maher’s wedding.”<sup>23</sup> Because it was unnecessary to infer a personal benefit under the gift theory in *Salman*, the Court’s discussion of the brothers’ closeness signaled that the Court views the close standard positively.

B. *SALMAN* DID NOT IMPLIEDLY REJECT THE CLOSE STANDARD

*Martoma* claimed that the “logic underpinning” *Salman* proves that *Salman* impliedly rejected the close standard and required an imposition of the two-pronged *Martoma* standard.<sup>24</sup> Section B will explain why each prong of the *Martoma* standard is neither compelled by nor consistent with the logic of *Salman* and *Dirks*. Section I.B.1 will address the first prong—“the disclosure resembles trading by the insider followed by a gift of the profits to the recipient”<sup>25</sup>—and section I.B.2 will address the second prong—“the information was disclosed with the expectation that [the recipient] would trade on it.”<sup>26</sup>

1. An Inference That an Insider Who Gifts Information to a Recipient Will Indirectly Benefit from the Recipient’s Pecuniary Gain Is Only Appropriate Where an Insider and Recipient Share a Close Relationship

The *Martoma* standard’s first prong derives from *Martoma*’s assertion that the justification in *Salman*—that the tipper would personally benefit from “trad[ing] on [inside] information . . . himself and then giv[ing] the proceeds as a gift to his brother” and thus the tipper “effectively achieve[s] the same result by disclosing the information to [the tippee] for the purpose of allowing [the tippee] to trade on it,”<sup>27</sup>—is “an observation that

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<sup>22</sup> *Salman*, 137 S. Ct. at 424.

<sup>23</sup> *Id.*

<sup>24</sup> *Martoma*, 869 F.3d at 71.

<sup>25</sup> *Id.* at 82.

<sup>26</sup> *Id.* at 70 (internal quotation marks omitted) (quoting *Salman*, 137 S. Ct. at 428).

<sup>27</sup> *Martoma*, 869 F.3d at 71 (internal quotation marks omitted) (quoting *Salman*, 137 S. Ct. at 427–28).

holds true even if the tipper and tippee were . . . [not] close friends.”<sup>28</sup> This assertion is in turn premised on *Martoma*’s interpretation of the nature of the personal benefit gained by a tipper that gifts inside information as follows: “the personal benefit one receives from giving a gift of inside information is *not* the friendship or loyalty or gratitude of the recipient of the gift; it is the imputed pecuniary benefit of having effectively profited from the trade oneself and given the proceeds as a cash gift.”<sup>29</sup>

Though *Martoma* branded the personal benefit gained by a tipper as an “imputed pecuniary benefit,”<sup>30</sup> in effect, *Martoma* described the personal benefit as an *indirect* pecuniary benefit. This argument is strongly evidenced where *Martoma* described the tipper’s pecuniary benefit as the benefit of having “*effectively* profited.”<sup>31</sup> Accordingly, *Martoma* held that the indirect pecuniary benefit gained by a tipper is the same regardless of how close the tipper is to the tippee.

*Martoma*’s claim cannot stand because, as a matter of common experience and logic, the closeness of a relationship affects a gift giver’s indirect pecuniary benefit in two primary fashions. First, a close relationship makes it reasonable to assume that the gift recipient will use his prosperity, at least in part, to indirectly benefit the gift giver. As Justice Breyer said at oral argument in *Salman*, “to help a close family member is like helping yourself.”<sup>32</sup> It is easy to imagine how a person’s close relationship to another would enable the former person to share in the latter’s pecuniary gains. For instance, where a tipper and tippee are close, one would expect that the tipper might be invited to dinners, trips, or other benefits that are the fruits of the tippee’s pecuniary gains. Second, a close relationship creates a feeling of an obligation to provide for the close friend’s security and stability. Thus, a person’s close relationship with a friend or relative also enables the tipper’s indirect pecuniary gain because a close friend or relative’s security and stability means that the tipper’s

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<sup>28</sup> *Martoma*, 869 F.3d at 68 (internal quotation marks omitted) (quoting *United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014)).

<sup>29</sup> *Martoma*, 869 F.3d at 72. *Salman* does not appear to confine a giftor-tipper’s personal benefit to imputed pecuniary gains. *Salman* upheld jury instructions providing that a personal benefit includes “the benefit one would obtain from simply making a gift of confidential information to a trading relative,” thereby suggesting that friendship, loyalty, and gratitude could properly be considered personal benefits. *Salman*, 137 S. Ct. at 429. For the sake of brevity, this paper does not further discuss this point.

<sup>30</sup> *Martoma*, 869 F.3d at 72.

<sup>31</sup> *Id.* (emphasis added). “Effectively” means “in an indirect way.”

*Effectively*, MERRIAM-WEBSTER, <https://www.merriam-webster.com/dictionary/effectively> [<https://perma.cc/G298-6PRM>] (last updated Mar. 14, 2018).

<sup>32</sup> Transcript of Oral Argument at 8, *Salman*, 137 S. Ct. 420 (No. 15-628).

obligation to support that friend or relative has been lifted. Justice Kennedy summarized this sentiment at oral argument in *Salman*, stating: “you certainly benefit from giving to your family . . . . [I]t helps you financially because you make them more secure,”<sup>33</sup> which in turn means that “you” (the tipper) divert fewer funds to your family or close friends, thereby indirectly obtaining a pecuniary gain. Although Justice Breyer and Justice Kennedy were referring to family, since *Salman* dealt with two brothers, the same logic applies to close friends.

In contrast, without the existence of a close personal relationship, it is difficult to presume that a tipper would either: (a) indirectly share in benefits that are the fruits of the tipper’s pecuniary gain or (b) indirectly avoid a financial loss by being relieved of an obligation to assist the tpee. Without a close personal relationship, there is no inherent reason to assume that the recipient of a gift would eventually share the profits of the gift with the gift giver, and there is no reason to assume that the gift giver would have felt a personal obligation to assist the recipient with a financial need in the first place. Although a tipper could ultimately benefit from gifting information to tpees with whom he is not close in some circumstances, it cannot be inferred that the tipper does so generally.

2. A Test That Asks if “the Information Was Disclosed with the Expectation That the Recipient Would Trade on It” Is a Subjective Rather than Objective Analysis

In *Dirks*, the Court announced that the personal benefit analysis is objective.<sup>34</sup> The *Martoma* standard’s second prong impermissibly focuses the personal benefit analysis on the tipper’s subjective intent rather than on objective facts indicating personal benefit. Of course, a tipper’s subjective purpose is relevant to the overall inquiry of whether the tipper fraudulently disclosed inside information in breach of his fiduciary duty. To impose tpee liability under the gift theory, both *Dirks* and *Salman* require that the tipper’s purpose is to gift inside information.<sup>35</sup> But, in *Dirks*, the Court explained that the personal benefit test—the test used to determine whether the tipper made the disclosure for an improper purpose—requires an objective analysis.<sup>36</sup> An objective analysis means

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<sup>33</sup> Transcript of Oral Argument at 11–12, *Salman*, 137 S. Ct. 420 (No. 15-628).

<sup>34</sup> See *Dirks v. SEC*, 463 U.S. 646, 663 (1983) (“[T]o determine . . . whether there has been a breach of duty by the insider . . . requires courts to focus on objective criteria, *i.e.*, whether the insider receives a direct or indirect personal benefit from the disclosure . . .”).

<sup>35</sup> See *Salman*, 137 S. Ct. at 427 (quoting *Dirks*, 463 U.S. at 667, which found no tpee liability in part because the tippers did not have the “purpose to make a gift of valuable information to [the tpee]”).

<sup>36</sup> See *supra* note 34 and accompanying text.

that “the courts are not required to read the parties’ minds.”<sup>37</sup> *Salman* reaffirmed *Dirks*’ holding that “in determining whether a tipper derived a personal benefit” courts must “focus on objective criteria.”<sup>38</sup> Although *Salman* did so in a somewhat conclusory fashion, the Court applied objective criteria in its gift theory analysis. The *Salman* Court held that the tipper gifted information to “his brother, . . . a trading relative,” which was “sufficient to resolve the case at hand.”<sup>39</sup> By directing juries to concentrate on the tipper’s expectations, *Martoma* focuses the personal benefit analysis on the tipper’s subjective intentions rather than on objective facts and circumstances indicating the tipper gained a personal benefit.

*Martoma* suggests that a tipper’s intentions can be proven through “circumstantial evidence,”<sup>40</sup> but it seems improbable that circumstantial evidence would redirect the jury’s inquiry to be an objective one, unless the circumstantial evidence concerned proof that the tipper and tippee enjoyed a close relationship. Most likely, without evidence of a close relationship, juries would have few objective facts to examine to determine a tipper’s intentions. *Martoma* unhelpfully assures that “not all insider trading cases rely on circumstantial evidence” because “the tipper may cooperate with the government and testify” as to his expectations.<sup>41</sup> Surely, an analysis that is reliant on a tipper’s offering of his subjective testimony cannot rightfully be considered to meet the Supreme Court’s requirement that the gift theory analysis be objective.

## II. THE PROPER DEFINITION OF FRIENDSHIP: AN ARGUMENT FOR THE CLOSE STANDARD

For the reasons discussed above, a definition of friendship that does not require any level of familiarity between parties (the *Martoma* standard) is an improper definition of friendship under *Dirks* and *Salman*. However, an open question remains concerning the dichotomy posed in *Newman*: whether it is sufficient for the tipper-tippee to be “casual acquaintances” or whether the parties must have a close relationship.<sup>42</sup> If the parties are required to have a close relationship to be friends, then by definition, tipper-tippees who are mere acquaintances cannot be friends because an acquaintance is “a person whom one knows but who is not a particularly *close* friend.”<sup>43</sup>

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<sup>37</sup> *Dirks*, 463 U.S. at 663.

<sup>38</sup> *Salman*, 137 S. Ct. at 427 (quoting *Dirks*, 463 U.S. at 663).

<sup>39</sup> *Salman*, 137 S. Ct. at 427.

<sup>40</sup> *United States v. Martoma*, 869 F.3d 58, 72 (2d Cir. 2017).

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

<sup>42</sup> *See United States v. Newman*, 773 F.3d 438, 453 (2d Cir. 2014).

<sup>43</sup> *Acquaintance*, MERRIAM-WEBSTER, <https://www.merriam-webster.com/dictionary/acquaintance> [<https://perma.cc/MW9A-T7SC>] (last updated Mar. 6, 2018) (emphasis added).

Part II of this paper posits that tipper-tippees must be more than mere acquaintances under the gift theory and that the close standard is the proper definition of friendship. Section A supports this proposition by demonstrating that previous opinions have applied the friendship requirement in a manner consistent with the close standard. Section A proves that prior courts' (1) uses of the word "friend" and (2) application of the friendship requirement support the close standard definition of friend. Next, section B discusses why the close standard is a fitting definition as a matter of policy.

A. PRIOR DECISIONS HAVE INTERPRETED AND APPLIED "FRIENDSHIP"  
TO REQUIRE A CLOSE TIPPER-TIPPEE RELATIONSHIP

1. Courts Differentiate Between the Terms "Friend" and "Acquaintance"

Few courts have mentioned the term "acquaintance" in discussing the friendship requirement of the gift theory. The courts that have done so used the term in such a way that suggests those courts view acquaintance relationships as relationships that fall short of the friendship requirement of the gift theory. In *SEC v. Sargent*, describing the tipper-tippee relationship, the First Circuit noted that the tipper "had referred at least 75 of his relatives, friends, and acquaintances to [the tippee] . . . ." <sup>44</sup> By referencing "friends" and "acquaintances" separately, the First Circuit acknowledged that acquaintances do not qualify as friendships. Unsurprisingly, *Newman* described the tipper-tippees in question as "casual acquaintances" as opposed to friends. <sup>45</sup> *Newman*'s characterization was legitimized when the Ninth Circuit, in *United States v. Salman*, described the *Newman* tipper-tippees as "acquaintance[s]," despite ultimately rejecting *Newman*'s requirement that in exchange for the information the tippee must give the tipper something of a "pecuniary or similarly valuable nature." <sup>46</sup> Following *Newman*, the First Circuit, in *United States v. Parigian*, held that a tipper and tippee "were friends" and not "just any casual acquaintance[s]." <sup>47</sup> In 2017, in a discussion about disgorgement for a violation of Rule 10b-5, the Northern District of California discussed the defendant's assurances that he would not again trade where his "family, friends or acquaintances work," and stated the belief that *Salman* and *Dirks* held that the gift theory applies where a gift is made to a "close friend or relative," thereby demonstrating the court's

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<sup>44</sup> 229 F.3d 68, 72 (1st Cir. 2000).

<sup>45</sup> *Newman*, 773 F.3d at 453.

<sup>46</sup> 792 F.3d 1087, 1092–93 (9th Cir. 2015), *aff'd*, 137 S. Ct. 420 (2016) (quoting *Newman*, 773 F.3d at 452).

<sup>47</sup> 824 F.3d 5, 8, 14 (1st Cir. 2016).

view that acquaintances do not qualify as friends.<sup>48</sup> Collectively, these courts' different uses of the terms "friend" and "acquaintance" support the view that courts have interpreted "friendship" to require a closer relationship than a mere acquaintanceship.

## 2. Courts Applying the Friendship Requirement Demonstrate That a Tipper and Tippee Must be Close for the Friendship Requirement to be Satisfied

Previous opinions applying the friendship requirement provide strong evidence that courts have interpreted "friendship" under the gift theory to include close friends but not acquaintances—people that merely know one another.<sup>49</sup> Previous cases have found tipper-tippees to be friends where there is a high quality relationship and specifically where at least one of the following can be established: (a) a history of engaging in social activities directly together or (b) a history of assisting one another with personal issues. Courts have also concluded that longer relationships as well as higher frequencies of interactions between parties are more demonstrative of friendship. Previous courts' examinations of the quality and quantity of interactions between parties hence indicate that parties must be closer than acquaintances—people who merely "know" one another but do not necessarily have a close companionship that furthers each other's welfare.

*a. History of Engaging in Social Activities Directly Together.* Prior cases' determinations of the types and quality of social activities that indicate the existence of a friendship support the proposition that the close standard is the proper definition of friendship. Participation in such activities directly with another person indicates that the two parties are more than just two people that "know" one another but rather are people that seek one another's companionship.<sup>50</sup> In *SEC v. Maio*, one of the reasons why the court found a friendship between the tipper and tippee was that "[o]ver the years of their mutual friendship," the tipper and tippee "traveled to Las Vegas together to gamble or attend prize fights and they

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<sup>48</sup> See *SEC v. Sabrdaran*, 252 F. Supp. 3d 866, 881, 910 (N.D. Cal. 2017) (emphasis added).

<sup>49</sup> Compare *Friend*, MERRIAM-WEBSTER, <https://www.merriam-webster.com/dictionary/friend> [<https://perma.cc/VCG3-3U6A>] (last updated Mar. 19, 2018) (defining "friend" to include "a favored companion"), with *Acquaintance*, MERRIAM-WEBSTER, <https://www.merriam-webster.com/dictionary/acquaintance> [<https://perma.cc/MW9A-T7SC>] (last updated Mar. 6, 2018) (defining "acquaintance" as "a person whom one knows but who is not a particularly close friend").

<sup>50</sup> See *supra* note 49.

regularly attended each other's family weddings.”<sup>51</sup> In *SEC v. Sargent*, the tipper and tippee were found to be friends, in part, because they engaged in activities such as meeting for dinner with their wives.<sup>52</sup> The Second Circuit, in *SEC v. Warde*, affirmed the lower court’s holding that the tipper and tippee had a “close friendship” based on evidence that they “would socialize several times a year” at each other’s homes, and “[t]ogether, they played cards, and discussed subjects ranging from art to the stock market.”<sup>53</sup> The First Circuit, in *Parigian*, found that the tipper received a personal benefit from disclosing the confidential information to the tippee in part because the two were “regular golfing companions.”<sup>54</sup>

Previous case law is also informative on activities that are insufficient to prove a friendship. Specifically, prior cases establish that association with a common group is alone insufficient to prove a friendship. For instance, in *Newman*, the Second Circuit found that the tippers and tippees could not be considered friends simply because they were “alumni of the same school or attended the same church.”<sup>55</sup> Even the somewhat conclusory analysis in *SEC v. Obus*—that “the undisputed fact that [the tipper and tippee] were friends from college is sufficient to send to the jury the question of whether [the tipper] received a benefit”—confirms that the tipper and tippee’s mere association with the same college would have been insufficient to prove a friendship.<sup>56</sup> What mattered is that the tipper and tippee had a direct, personal friendship.

Similarly, prior cases have distinguished professional relationships from friendships, finding that proof of a professional relationship alone does not amount to a friendship.<sup>57</sup> In *SEC v. Gaspar*, the court found that the tipper-tippee had a professional relationship as well as a friendship and indicated that the professional relationship alone, without the additional friendship, likely would have been insufficient to find that the “disclosures constituted a gift as described by the Court in *Dirks*.”<sup>58</sup> Likewise, in *SEC v. Maxwell*, a case involving a client who tipped his barber, the court held that the tipper and tippee “were not close personal friends” because “[o]ther than [a few] phone calls and [the tipper’s] haircut appointments,

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<sup>51</sup> 51 F.3d 623, 627 (7th Cir. 1995).

<sup>52</sup> See 229 F.3d 68, 72 (1st Cir. 2000).

<sup>53</sup> *SEC v. Downe*, 969 F. Supp. 149, 152 (S.D.N.Y. 1997), *aff’d sub nom.* *SEC v. Warde* 151 F.3d 42, 49, 50 (2d Cir. 1998).

<sup>54</sup> *United States v. Parigian*, 824 F.3d 5, 9 (1st Cir. 2016).

<sup>55</sup> *United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014).

<sup>56</sup> 693 F.3d 276, 291 (2d Cir. 2012).

<sup>57</sup> See, e.g., *SEC v. Maxwell*, 341 F. Supp. 2d 941, 949 (S.D. Ohio 2004) (asserting that the tipper and tippee in *Sargent* were friends not because of their dentist-patient relationship, but rather because they “socialized and had dinner together on occasion”).

<sup>58</sup> No. 83 Civ. 3037 (CBM), 1985 WL 521, at \*17 (S.D.N.Y. Apr. 16, 1985).

[the tipper and tippee] did not socialize with each other.”<sup>59</sup> The court suggested that it might have found the tipper and tippee were friends were there evidence that the two “socialize[d] outside of [the tipper’s] haircut appointments.”<sup>60</sup>

Therefore, direct and joint participation in social activities—such as traveling, dining, entertaining at home, and engaging in hobbies such as golfing—have caused tipper-tippee relationships to be adjudicated as friendships whereas mere common affiliations with professional or social groups have not. This supports the proposition that “friends” under the gift theory includes close friends but not mere acquaintances.

*b. History of Assisting One Another with Personal Issues.* Previous cases also establish that a history of assisting is another factor in proving a friendship between the tipper and tippee. These cases indicate that courts have viewed friendship as requiring more than merely knowing one another; rather, to be friends, two people must promote each other’s well-being.<sup>61</sup> For instance, in *In re Motel 6 Securities Litigation*, the court held that the tipper and tippee “were good friends,” as evidenced by the tipper “supporting [the tippee], who was dying of AIDS, giving him gifts and sending him \$1000 per month.”<sup>62</sup> Similarly, in *Maio*, the court stated that “perhaps the best evidence of [the tipper and tippee’s] close friendship” is that the tipper promised a mutual friend that he would take care of the tippee.<sup>63</sup> The tipper did in fact do so, providing the tippee with “the largest personal loan [the tipper] ever made,” even though the tippee “signed no promissory note, paid no interest, and gave no mortgage.”<sup>64</sup> In *Sargent*, the First Circuit also found that the tipper and tippee were friends in part because the tipper “had referred at least 75 of his relatives, friends, and acquaintances to [the tippee] for their dental work.”<sup>65</sup> The tippee likewise had a history of assisting the tipper in personal endeavors; he would “periodically” provide the tipper with “contacts” and “funds” for the local

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<sup>59</sup> 341 F. Supp. 2d at 944.

<sup>60</sup> *Id.* at 948.

<sup>61</sup> *See Friend*, MERRIAM-WEBSTER, <https://www.merriam-webster.com/dictionary/friend> [<https://perma.cc/VCG3-3U6A>] (last updated Mar. 19, 2018) (defining “friend” to include “a favored companion” and “one attached to another by affection”); *see also Affection*, MERRIAM-WEBSTER, <https://www.merriam-webster.com/dictionary/affection> [<https://perma.cc/US2M-NFLF>] (last updated March 9, 2018) (defining “affection” to include “caring for someone”).

<sup>62</sup> 161 F. Supp. 2d 227, 230 n.1 (S.D.N.Y. 2001).

<sup>63</sup> *SEC v. Maio*, 51 F.3d 623, 627 (7th Cir. 1995).

<sup>64</sup> *Id.*

<sup>65</sup> *SEC v. Sargent*, 229 F.3d 68, 72 (1st Cir. 2000).

chamber of commerce, an organization in which the tipper was involved.<sup>66</sup> The tippee additionally provided the tipper with other personal favors like hiring the tipper's sister-in-law to decorate the tippee's home.<sup>67</sup>

Prior cases also show that a lack of a history of support between a tipper and tippee increases the likelihood that a court will not find a friendship between the tipper and tippee. For instance, in *Maxwell*, one of the reasons the court found the tipper and tippee were not friends was: “[t]here was no history of substantial loans or personal favors between [the tipper and tippee].”<sup>68</sup> Because the courts have found a history of personal support between a tipper and tippee is indicative of friendship, it is therefore most likely that the proper definition of friendship requires a close relationship rather than a relationship wherein the parties are merely familiar with one another.

*c. Length of Relationship and Frequency of Interactions.* Prior cases indicate that a higher frequency of interactions, extended over a longer period, support the finding of a friendship. Accordingly, these cases support the proposition that the gift theory requires parties to be closer than mere acquaintances to qualify as “friends.” Presumably, relationships that last over longer periods and consist of frequent interactions are ones wherein the parties are more than just two people that “know” one another; rather, they are people with meaningful relationships that provide the parties with companionship and affection.<sup>69</sup>

For instance, in *Maio*, where the tipper and tippee were found to be friends, the court described the tipper and tippee's relationship as one that took place “[o]ver the years.”<sup>70</sup> In *Warde*, the Second Circuit upheld the district court's holding in *Downe* that the tipper and tippee had a close friendship partially because “[t]hey would socialize several times a year.”<sup>71</sup> Additionally, in *United States v. Evans*, the Seventh Circuit found that the tipper and tippee were “friends” because “they talked daily via email or phone and saw each other frequently.”<sup>72</sup> Although *Warde* and *Evans* found different frequencies to be demonstrative of friendship—with *Evans* representing the upper end of the spectrum—in both cases the parties interacted more frequently than two acquaintances would. Hence, prior cases demonstrate that a relationship is more likely to constitute a friendship where the people in the relationship interact with one another at a frequency at which close friends would be expected to interact.

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<sup>66</sup> *Id.*

<sup>67</sup> *See id.*

<sup>68</sup> SEC v. Maxwell, 341 F. Supp. 2d 941, 948 (S.D. Ohio 2004).

<sup>69</sup> *See supra* notes 49 and 61.

<sup>70</sup> SEC v. Maio, 51 F.3d 623, 627 (7th Cir. 1995).

<sup>71</sup> SEC v. Downe, 969 F. Supp. 149, 152–53 (S.D.N.Y. 1997), *aff'd sub nom.* SEC v. Warde 151 F.3d 42 (2d Cir. 1998).

<sup>72</sup> United States v. Evans, 486 F.3d 315, 319 (7th Cir. 2007).

In conclusion, the *Martoma* standard, discussed above in Part I, does not comport with precedent because under the *Martoma* standard, a tipper and tippee can be deemed friends even if they hardly know one another. Under the *Martoma* standard, a tipper and tippee need not have a history of partaking in social activities together or a history of assisting one another with personal issues for an adequate period of time.

#### B. POLICY SUPPORT

In *Chiarella*, the landmark Supreme Court opinion holding that Rule 10b-5 prohibits insider trading, the Court explained that the prohibition is premised on an insider's relationship of trust and confidence—for example, the fiduciary duty that an insider owes to a corporation's shareholders—instead of a “general duty between all participants in market transactions to forgo actions based on material, nonpublic information.”<sup>73</sup> *Dirks* added that “[n]ot all breaches of fiduciary duty in connection with a securities transaction . . . come within the ambit of Rule 10b-5.”<sup>74</sup> Rather, there must be fraud that “derives from the inherent unfairness involved where one takes advantage of information” for a “personal benefit.”<sup>75</sup> *Dirks* provided one instance that does not constitute fraud and fails the personal benefit test: disclosing inside information to expose corporate fraud.<sup>76</sup> Other courts have added other instances that fail the personal benefit test, such as inadvertent disclosures.<sup>77</sup>

In *Dirks*, the Court provided three examples of objective circumstances that justify an inference of personal benefit: (a) the insider received a pecuniary gain or reputational benefit that will translate into future earnings (the “pecuniary theory”); (b) a relationship exists between the insider and tippee that “suggests a *quid pro quo* from the latter, or an

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<sup>73</sup> *Chiarella v. United States*, 445 U.S. 222, 228, 233 (1980); see 17 C.F.R. § 240.10b-5 (2017).

<sup>74</sup> *Dirks v. SEC*, 463 U.S. 646, 654 (1983) (internal quotation marks omitted) (quoting *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472 (1977)).

<sup>75</sup> *Dirks*, 463 U.S. at 654 (internal quotation marks omitted) (quoting *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936 (1968)); see also *SEC v. Maxwell*, 341 F. Supp. 2d 941, 948 (S.D. Ohio 2004) (explaining SEC's burden to prove not merely that tipper disclosed information but also that tipper received an “actual benefit” from disclosing information).

<sup>76</sup> See *Dirks*, 463 U.S. at 667.

<sup>77</sup> See, e.g., *SEC v. Obus*, 693 F.3d 276, 287 (2d Cir. 2012) (stating tippee liability would likely not be found where a tipper's disclosure is inadvertent); *SEC v. Switzer*, 590 F. Supp. 756, 758, 766 (W.D. Okla. 1984) (finding football coach who overheard inside information from person attending track meet not liable for trading on information).

intention to benefit the particular recipient” (the “quid pro quo theory”); or (c) the insider made “a gift of confidential information to a trading relative or friend” (the “gift theory”).<sup>78</sup> These examples represent a spectrum of direct to indirect—and also tangible to intangible—personal benefits, with the pecuniary gain theory providing the most direct or tangible personal benefit and the gift theory providing the most indirect or intangible personal benefit. To wit, the gift theory as articulated in *Dirks* appears to be the floor of personal benefit—the minimum benefit that a tipper must gain to even be considered to have personally benefitted from his disclosure of inside information—as it provides the most indirect or intangible personal benefit of the three guiding examples from *Dirks*.

Interpreting the friendship requirement of the gift theory to be confined to a narrower set of relationships as opposed to an indefinitely expansive set of relationships is consistent with the underlying policy of confining insider trading violations to instances where the tipper actually benefits personally from the disclosure. If a tipper could be said to personally benefit from merely disclosing information and having the expectation that the tippee would trade on the information, then virtually all disclosures, other than inadvertent disclosures, would personally benefit the tipper. As most disclosures are not inadvertent, the rule would functionally prohibit all disclosures of inside information, in direct contradiction of *Chiarella*.

To date, the Court has only carved out one instance wherein an advertent disclosure is made for a proper purpose: exposure of corporate fraud.<sup>79</sup> The Court has not, however, announced that this is the one instance wherein the purpose of the disclosure is for a legitimate corporate purpose. Likewise, the Court has not provided that all legitimate corporate purposes must be as selfless as exposing corporate fraud. One can easily imagine disclosures that would provide little to no personal benefit to the tipper even though they may not be as selfless as disclosures made to expose corporate fraud. For instance, picture a scenario wherein an executive officer of a company discloses inside information about an upcoming transaction to an officer of a bank to secure the bank’s financial support in the transaction. If the bank officer subsequently traded on this information, under *Martoma*, the corporate executive would be deemed to have obtained a personal benefit. Such a result is shocking, particularly because this instance does not present a clear-cut example of a disclosure made for personal benefit.

Thus, to confine liability to those insiders that personally benefit from disclosure, the boundaries constructed by *Dirks* should be respected. Specifically, the floor—the gift theory—should be interpreted to apply where tipper and tippee have a close relationship. Though gifts to other types of tippees may personally benefit the tipper in some situations, such

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<sup>78</sup> *Dirks*, 463 U.S. at 663–64.

<sup>79</sup> *See id.* at 667.

instances should not be entitled to an inference of personal benefit. If such instances were entitled to an inference of a personal benefit, the boundaries constructed by *Dirks* would be practically meaningless. Under the *Martoma* standard, certain disclosures made for potentially legitimate corporate purposes would not have their day in court; they would simply be categorized as disclosures not made to expose corporate fraud and ergo disclosures made for a personal benefit. Such a rule would impose tippee liability even for disclosures made for purposes that are closer to the side of legitimate corporate purposes than the side of personal benefit purposes.

#### CONCLUSION

A universal adoption of the close standard is proper because the standard comports with *Dirks* and *Salman* and is supported by previous cases and policy considerations. Furthermore, a universal adoption of the close standard is advisable because it would aid the uniform application of insider trading law. Even after *Salman*, some courts have expressed hesitation to define how close a tipper-tippee must be under the gift theory.<sup>80</sup> A universal adoption would create consistency between the courts and minimize the differences between the types of cases wherein tippee liability is imposed or not imposed.

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<sup>80</sup> See, e.g., *United States v. Bray*, 853 F.3d 18, 27 (1st Cir. 2017) (“We need not determine . . . how ‘close’ a tipper-tippee relationship must be . . .” because, “[i]nstead, we simply hold that the record’s evidence . . . provided a sufficient basis for a reasonable jury to conclude that [the tipper] acted in expectation of a personal benefit.”).