United States v. Blaszczak: Second Circuit Ruling Heightens Risks of Insider Trading Investigations and Prosecutions

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On December 30, 2019, the Second Circuit issued an opinion in *United States v. Blaszczak* that raises the investigative and prosecutorial risk in certain types of insider trading cases in two significant respects. 2019 WL 7289753 (2d Cir. Dec. 30, 2019). First, in a departure from traditional insider trading principles under the Securities Exchange Act ("Title 15 securities fraud"), the Second Circuit held in *Blaszczak* that the government can prosecute insider trading under both the criminal securities fraud provisions added in the 2002 Sarbanes-Oxley Act ("Title 18 securities fraud") and the wire fraud statutes without any proof of a "personal benefit" to the tipper—that is, the government need not allege or prove that the tipper breached a duty in exchange for a direct or indirect personal benefit, or that the downstream tippee knew of a personal benefit to the tipper. Second, in a 2-1 decision that featured a forceful dissent by Judge Amalya L. Kearse, the Second Circuit adopted an expansive definition of "property" for purposes of the wire fraud and Title 18 securities fraud statutes, holding that "predecisional" confidential government information relating to planned medical treatment reimbursement rate changes constituted government "property" necessary to bring insider trading cases under an embezzlement or misappropriation theory. These holdings heighten the risks of criminal prosecution in insider trading cases where there is limited-to-no evidence of a direct or indirect personal benefit to the tipper or that the downstream tippee knew of any personal benefit to the tipper, as well as in cases involving disclosure of nonpublic government information.

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Blaszczak Factual and Procedural Background

In *Blaszczak*, the United States Department of Justice ("DOJ") alleged that, between 2009 and 2014, certain Centers for Medicare & Medicaid Services ("CMS") employees disclosed confidential information to David Blaszczak, a former CMS employee who become a "political intelligence" consultant for certain hedge funds. Blaszczak allegedly provided confidential information relating to the timing and substance of CMS' planned changes to its reimbursement rates for certain medical treatments to employees of the healthcare-focused hedge fund Deerfield Management Company, L.P. These employees allegedly directed Deerfield to short stocks of healthcare companies that would be hurt by the planned reimbursement rate changes.

The DOJ indicted Blaszczak, one CMS employee, and two Deerfield employees for the alleged insider trading scheme, including counts for conspiracy, conversion of U.S. property, Title 15 securities fraud, wire fraud, and Title 18 securities fraud. At an April 2018 trial, the district court instructed the jury, as relevant here, that, in order to convict on the Title 15 securities fraud count, the jury had to find that a CMS employee tipped the confidential CMS information in exchange for a personal benefit and that Blaszczak and the Deerfield employees knew that a CMS insider had done so in exchange for a personal benefit. Notably, the district court refused to give this "personal benefit" instruction on the wire fraud and Title 18 securities fraud counts. On May 3, 2018, the jury returned a split verdict that, in relevant part, acquitted all defendants on the Title 15 counts, but found the defendants guilty on other counts, including conversion, wire fraud, and (except for the

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CMS employee) Title 18 securities fraud. The defendants appealed on a number of grounds, including that the district court erred by refusing to include the “personal benefit” test in the Title 18 jury instructions and that the confidential CMS information did not constitute CMS’ “property” supporting conviction on the wire fraud and Title 18 securities fraud counts.

Personal Benefit Requirement Does Not Apply in Title 18 cases

The Supreme Court engrafted a “personal benefit” test on to criminal or civil insider trading cases over 35 years ago in *Dirks v. SEC*, 463 U.S. 646 (1983). In that case, Dirks, a broker-dealer officer, had been charged by the SEC with a civil violation of the Title 15 securities fraud statutes based on his receipt of material nonpublic information (“MNPI”) from a company’s insiders regarding fraud at that company, which information he then shared with investors who later sold the company’s stock. The Supreme Court held that tippers are only liable where they breach a fiduciary duty to the company’s shareholders, and they only breach such a duty where they “personally . . . benefit, directly or indirectly, from [their] disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach” by those who passed on or traded on the inside information. Because the insiders in *Dirks* did not benefit from their disclosures to Dirks, but rather “were motivated by a desire to expose the fraud,” they did not breach any fiduciary duty; Dirks thus “had no duty to abstain from use of the inside information that he obtained.”[1]

What constitutes a “personal benefit” under *Dirks* has been the subject of significant litigation in recent years, including the extent to which gifting of confidential information to friends or relatives satisfied the personal benefit test. *Compare United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014) (vacating insider trading convictions for lack of personal benefit where government failed to prove a “meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature”), *with Salman v. United States*, 137 S. Ct. 420 (2016) (affirming conviction where tipper gifted confidential information to a trading relative).

In the 2002 Sarbanes-Oxley Act, Congress added a new securities fraud provision to the criminal code, 18 U.S.C. § 1348, to “supplement the patchwork of existing technical securities law violations with a more general and less technical provision, with elements and intent requirements comparable to current bank fraud and health care fraud statutes.” S. Rep. No. 107-146, at 14 (2002). The defendants in *Blaszczak* challenged their convictions under this Title 18 securities fraud provision, arguing that the *Dirks* “personal benefit” test should apply to Title 18 charges, just as it does to Title 15 charges.

In analyzing this question, the Second Circuit in *Blaszczak* noted that neither the Title 15 nor Title 18 securities fraud provisions include in their text a personal benefit test. “Rather, the personal-benefit test [under Title 15] is a judge-made doctrine premised on the Exchange Act’s statutory purpose … of eliminating the use of inside information for *personal advantage*.” (internal quotation marks omitted; emphasis in original). The Second Circuit stated that, on the contrary, “Section 1348 was added to the criminal code by the Sarbanes-Oxley Act of 2002 in large part to overcome the ‘technical legal requirements’ of the Title 15 fraud provisions.” The Second Circuit therefore concluded, “[g]iven that Section 1348 was intended to provide prosecutors with a different – and broader – enforcement mechanism to address securities fraud than what had been previously provided in the Title 15 fraud provisions, we decline to graft the *Dirks* personal-benefit test onto the elements of Title 18 securities fraud.” The Court also noted that the personal-benefit test did not apply to the overlapping wire fraud statute.

The Second Circuit’s decision is consistent with those of two Northern District of Georgia courts that previously examined this issue and similarly rejected a personal benefit test under Title 18 securities fraud. *See United States v. Melvin*, 143 F. Supp. 3d 1354 (N.D. Ga. 2015); *United States v. Slawson*, 2014 WL 5804191 (N.D. Ga. Nov. 7, 2014),

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adopted 2014 WL 6990307 (N.D. Ga. Dec. 10, 2014). While the Second Circuit appears to be the first Court of Appeals to have reached this issue, prosecutors' ability to reach well beyond the geographic boundaries of the Second Circuit in policing the marketplace renders the *Blaszczak* ruling significant precedent.

Predecisional Confidential Government Information Constitutes Government Property

The defendants in *Blaszczak* also challenged their Title 18 convictions on the grounds that there was insufficient evidence to prove that they defrauded CMS of any "property" because a government agency's confidential information was purportedly not "property" belonging to that agency. In assessing this question, the court analyzed two Supreme Court decisions: *Carpenter v. United States*, 484 U.S. 19 (1987), and *Cleveland v. United States*, 531 U.S. 12 (2000).

In *Carpenter*, a Wall Street Journal ("WSJ") reporter and three co-conspirators were convicted of mail and wire fraud where a reporter gave his co-conspirators advance nonpublic information regarding the timing and contents of his columns on particular stocks, so they could trade in advance of his column's publication. The defendants argued that they did not obtain any "money or property" from the victim of the fraud, the WSJ, a necessary element for their fraud convictions. The Supreme Court disagreed, explaining that, while intangible, "the publication schedule and contents of the [] column" constituted confidential business information belonging to the WSJ, and "[c]onfidential business information has long been recognized as property."

In *Cleveland*, the Supreme Court analyzed whether fraudulently-obtained Louisiana state video poker licenses constituted Louisiana's "property" for purposes of the mail fraud statute. Distinguishing *Carpenter*, the Supreme Court noted that "whatever interests Louisiana might be said to have in its video poker licenses, the State's core concern is *regulatory*" and those interests "cannot be economic." (emphasis in original). Because "the State did not decide to venture into the video poker business," but instead "permit[ted], regulate[d], and tax[ed] private operators of the games," the Court concluded that the licenses in the State's hands did not constitute "property."

In a 2-1 decision, the Second Circuit in *Blaszczak* found the confidential CMS information more analogous to the WSJ's confidential information in *Carpenter* than the state licenses in *Cleveland.* Specifically, in contrast to the exercise of "traditional police powers" in *Cleveland,* the Second Circuit concluded that "CMS's right to exclude the public from accessing its confidential predecisional information squarely implicates the government's role as property holder, not as sovereign." In addition, while the court did "not read *Cleveland* as strictly requiring the government's property interest to be 'economic' in nature, the government presented evidence that CMS *does* have an economic interest in its confidential predecisional information," including "that CMS invests time and resources into generating and maintaining the confidentiality of" the information. (emphasis in original). The court therefore held that, "in general, confidential government information may constitute government 'property' for purposes of" wire fraud and Title 18 securities fraud charges.

Judge Kearse dissented, arguing that confidential CMS information did not constitute government "property" because "CMS is not a business…; it is a regulatory agency" and, unlike in *Carpenter*, "information is not CMS's 'stock in trade.'" Given the dissent, which increases the possibility of further review either by the Second Circuit *en banc* or by the Supreme Court, the Second Circuit's December 30 opinion may not be the last decision in this case.

Implications of *Blaszczak*

Blaszczak heightens the risk of DOJ investigation and prosecution in the subset of insider trading cases where there is limited-to-no evidence of personal benefit to the tipper or the

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downstream tippee's knowledge of the personal benefit, or cases that involve the disclosure of confidential government information.

In particular, by not requiring prosecutors to prove that the tipper embezzled or stole the information in exchange for a direct or indirect personal benefit, *Blaszczak* heightens the risk for analysts and others who communicate with company executives, employees, and other insiders to obtain investment-relevant information without providing any benefit to those employees. Investment professionals who trade while in possession of MNPI from company insiders, as well as whistleblowers who do not receive any personal benefit, could also see heightened risks of investigation and prosecution. In fact, while Dirks' conviction for Title 15 insider trading was reversed by the Supreme Court, an identical prosecution by the DOJ under Title 18's wire fraud and securities fraud provisions would likely be sustained under the reasoning in *Blaszczak*.

Indeed, it is difficult to square *Blaszczak* with *Dirks,* where the Supreme Court explained that "[w]hether disclosure is a breach of duty … depends in large part on the purpose of the disclosure." In fact, the Second Circuit itself commented in *Newman*, "*Dirks* counsels us that the exchange of confidential information for personal benefit is not separate from an insider's fiduciary breach; it *is* the fiduciary breach that triggers liability for securities fraud under Rule 10b–5." 773 F.3d at 447-448 (emphasis in original). With "the purpose of the disclosure" seemingly no longer relevant under Title 18 in the wake of *Blaszczak*, it is unclear what remains of the breach of fiduciary duty requirement in the context of Title 18 securities fraud.

Whether the DOJ will now use Title 18 to bring insider trading cases that it would not otherwise have brought in the past due to the absence of any personal benefit evidence remains unknown. But *Blaszczak* makes it more likely that prosecutors will routinely bring Title 18 securities fraud and wire fraud charges in conjunction with Title 15 charges, especially given the continually evolving case law regarding what constitutes a "personal benefit." Bringing both Title 15 and Title 18 charges could also offer the jury a way to compromise with a guilty verdict only on the easier-to-prove Title 18 charges. Indeed, one need look no further than the jury verdict in *Blaszczak* itself, in which the jury acquitted on the Title 15 charges where there was a personal benefit instruction, but convicted on the Title 18 charges where there was no such instruction. Because Title 18 is a criminal statute, this ruling may also create the peculiar—and inequitable—situation where the government is forced to prosecute a defendant criminally due to lack of personal benefits evidence and the SEC's inability to proceed with civil charges under Title 15. *Blaszczak* could therefore prompt the SEC to seek legislation creating an analogous provision to 18 U.S.C. § 1348 that does not have the "technical legal requirements" existing in Title 15 securities fraud provisions. It could also prompt the SEC to seek the removal of the personal benefit requirement from proposed insider trading legislation currently pending in Congress. *See* Insider Trading Prohibition Act, H.R. 2534 116th Cong. § 16A.

In addition, *Blaszczak's* holding that predecisional confidential government information constitutes government property heightens the risk of both SEC and DOJ investigations in cases involving trading while in possession of confidential executive agency information, whether obtained directly from a government employee or, as was the case in *Blaszczak*, from a consultant with access to government employees. This could include confidential government information covering a range of issues, including for example tariff policies, budgeting decisions, military actions, evaluations of a potential merger under anti-trust law, or the calculation of job growth or unemployment figures. Analysts and investors speaking with government personnel and "political intelligence" consultants with sources inside the government should therefore be especially wary about receiving and trading even in part based on confidential government information, particularly given that the DOJ will not be required under Title 18 to prove that the government tipper received any personal benefit from disclosure of the information.

The enhanced risks and uncertainties created by the Second Circuit's decision

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in *Blaszczak* heighten the need to consult with in-house and outside counsel whenever there is a concern that a firm, or one of its employees, may have obtained MNPI. *Blaszczak* also further highlights the need to review and update compliance policies and annual trainings, to be clear that the receipt of MNPI from any source and under any circumstances requires extreme care before using the information in connection with a securities transaction.

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[1] In *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991), and subsequent cases, courts extended the *Dirks* breach of fiduciary duty analysis to circumstances where a tippee is found to have breached a duty as a temporary insider and trading occurs.

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