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CLIENT ALERT

The Second Circuit Affirms an Easier Path to Prosecute Insider Trading

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On December 30, 2019, the United States Court of Appeals for the Second Circuit issued a 2-1 decision in *United States v. Blaszczak*, affirming guilty verdicts of four defendants who had been accused of participation in an insider trading scheme and thereafter convicted of conspiracy under 18 U.S.C. § 371, conversion of government property under 18 U.S.C. § 641, wire fraud under 18 U.S.C. § 1343, and securities fraud under 18 U.S.C. § 1348 ("Title 18 securities fraud" and together with "wire fraud," the "Title 18 fraud statutes"). Specifically, the government charged that the *Blaszczak* defendants were engaged in a scheme aimed at converting confidential government property from the Centers for Medicare & Medicaid Services ("CMS") and trading on the stolen information.

Traditionally, insider trading has been prosecuted pursuant to Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), codified at 15 U.S.C. § 78, and its corollary, Rule 10b-5. For more than thirty years, since the Supreme Court's decision in *Dirks v. SEC*, prosecutors seeking a conviction for insider trading have been required to establish proof beyond a reasonable doubt that the tipper received a "personal benefit" in exchange for breaching his or her fiduciary duty and disclosing material nonpublic information ("MNPI").[1] *Blaszczak* signifies a watershed moment within the context of insider trading and white collar prosecutions because it holds that: (1) the "personal-benefit" test from *Dirks* ***does not***

[1] *See Dirks v. SEC*, 463 U.S. 646, 662-664 (1983). The Second Circuit in *United States v. Newman* further clarified this test, holding that, within the context of the tippee, the government must prove that the "tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit[.]" 773 F.3d 438, 450 (2d Cir. 2014), *abrogated on other grounds by Salman v. United States*, 137 S. Ct. 420 (2016).

apply to the Title 18 fraud statutes; and (2) a government agency's confidential information constitutes "property" under the Title 18 fraud statutes.[2]

In *Blaszczak*, the Second Circuit was tasked with considering whether the term "defraud" should be construed to have the same meaning across the Title 18 fraud statutes and Rule 10b-5, so that the elements of insider-trading fraud were the same under each of these provisions. In declining to adopt this position, the majority noted that "[w]hile the Title 18 fraud statutes and Title 15 fraud provisions thus share similar text and proscribe similar theories of fraud, these common features have little to do with the personal-benefit test," which, as the majority described, is a "judge-made doctrine premised on the Exchange Act's statutory purpose."[3] The majority declined "to graft the *Dirks* personal-benefit test onto the elements of Title 18 securities fraud" given that 18 U.S.C. § 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[.]"[4] In *Blaszczak*, the Second Circuit became the first appellate court in the country to determine how, and to what extent, the Title 18 fraud statutes alter the requirements for proving insider trading.

The Second Circuit's decision in *Blaszczak* to not apply the personal-benefit test to the Title 18 fraud statutes confirms a new pathway that prosecutors in the Southern District of New York and beyond may pursue when charging insider trading, particularly against tippees (i.e., individuals who receive MNPI from a tipper). By freeing the government from having to prove a personal benefit under the Title 18 fraud statutes, *Blaszczak* has expanded the prosecutor's toolkit and may have ushered in a new species of insider trading prosecutions. Such prosecutions could have a far-reaching impact on investment advisors, hedge funds, and other firms that come in contact with MNPI from both the corporate realm and the world of political intelligence.

BLASZCZAK **AND THE SECOND CIRCUIT'S DECISION**

United States v. Blaszczak centered around David Blaszczak, a political intelligence consultant and former employee at CMS, who obtained MNPI concerning CMS's Medicare reimbursement decisions for radiation oncology treatment times and kidney dialysis. Among Blaszczak's alleged tippers was his friend, co-defendant Chris Worrall, who was a CMS employee during the relevant time. At various instances throughout 2009–2014, Blaszczak was found to have passed MNPI he received from Worrall to various clients, including two hedge fund employees. In its March 5, 2018 superseding indictment, the government charged the *Blaszczak* defendants with a slew of counts, including traditional Title 15 securities fraud, Title 18 securities fraud, wire fraud, conversion of government property, and conspiracy to commit the

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2 *United States v. Blaszczak*, Nos. 18-2811, 18-2825, 18-2867, 18-2878, slip op. at 2 (2d Cir. Dec. 30, 2019) (hereinafter "*Blaszczak*"). The Second Circuit also noted that CMS's confidential information constituted a "thing of value" under 18 U.S.C. § 641, conversion of government property. *Id.* at 39. A PDF of the opinion and Judge Kearse's dissent can be accessed here.

3 *Blaszczak*, slip op. at 28.

4 *Id.* at 31-32.

same.[5] During trial, the government failed to establish that the two hedge fund employee defendants knew who Worrall was, let alone knew that he received any personal benefit in exchange for breaching his fiduciary duty to CMS and providing Blaszczak with MNPI.

The district court judge instructed the jury, consistent with *Dirks*, that to convict the downstream tippees (the hedge fund employees) for Title 15 securities fraud, the jury was required to find that the tippees "knew that a CMS insider tipped the information in exchange for a personal benefit."[6] Conversely, the personal-benefit test was not included in the jury instructions for the wire fraud and Title 18 securities fraud counts.[7] Rather, to convict under the wire fraud statute, the jury had to find, among other elements, "the fraudulent appropriation to one's own use of the money or property [the CMS information] entrusted to one's care by someone else."[8] Similarly, for the Title 18 securities fraud counts, the jury could convict if it found, among other elements, "the existence of a scheme to defraud," which the district court defined as "a scheme to embezzle or convert confidential information from CMS by wrongfully taking that information and transferring it to his own use or the use of someone else."[9] After four days of deliberation, the jury convicted the defendants under some of the Title 18 counts but acquitted all of the defendants under the traditional Title 15 insider trading counts.[10]

On appeal, the defendants argued that the trial court erred in omitting the personal-benefit test from the jury instructions for the wire fraud and Title 18 securities fraud counts. The Second Circuit disagreed, finding no error. The majority opinion, authored by Judge Richard Sullivan, acknowledged that the Title 18 fraud statutes and the Title 15 fraud provisions both prohibited "schemes to defraud,"[11] and specifically schemes that involved the misappropriation or embezzlement of "money or goods entrusted to one's care by another."[12] The majority explained, however, that the similarities between the Title 15 and Title 18 provisions did not extend to the application of the personal-benefit test:

[T]he personal-benefit test is a judge-made doctrine premised on the Exchange Act's statutory purpose. As *Dirks* explained, in order to protect the free flow of information into the securities markets, Congress enacted the Title 15 fraud provisions with the limited purpose of . . . eliminat[ing] [the] use of inside information for *personal advantage*.[13]

5 *See id*. at 11-12.

6 *Id.* at 13.

7 *Id.*

8 *Id.* (internal quotations omitted).

9 *Id.* (internal quotations omitted).

10 *See id.* at 13-14.

11 *Id.* at 27 (internal quotations omitted).

12 *Id.* at 28 (internal quotations omitted).

13 *Id.* (emphasis in original) (internal quotations omitted).

Because one of the statutory purposes of the Securities Exchange Act of 1934 was to prevent individuals from abusing their status as insiders to obtain a personal advantage or benefit, the creation of a "personal-benefit" test was logical under the Title 15 context as a means of ensuring that the Exchange Act's purpose was effected.

However, the majority held that removing the personal-benefit test from this specific statutory context and applying it to Title 18 is untenable, given that the fraudulent scheme that Title 18 was intended to address is embezzlement. Effectively, the Second Circuit found that the "schemes to defraud" prohibited by the Title 18 fraud statutes are broader than those proscribed by the Title 15 provisions and not limited to preventing the use of inside information for personal advantage. According to the majority, because embezzlement inherently involved a breach of duty, "there is likewise no additional requirement that the government prove a breach of duty in a specific manner, let alone through evidence that an insider tipped confidential information in exchange for a personal benefit."[14] Ultimately, because the personal-benefit test relied upon the Exchange Act and was "not grounded in the embezzlement theory of fraud," the Second Circuit declined to extend the personal-benefit test to the Title 18 fraud statutes.[15]

The Second Circuit also explained that Section 1348 of Title 18, which was codified by the Sarbanes-Oxley Act of 2002, was intended to "overcome the technical legal requirements of the Title 15 fraud provisions."[16] In analyzing Section 1348's legislative history, the majority noted that "Congress intended for Section 1348 to supplement the patchwork of existing technical securities law violations with a more general and less technical provision[.]"[17] Because Section 1348's legislative history suggested that the statute was intended to provide federal prosecutors with broader criminal enforcement mechanisms than the ones previously afforded to them under the Title 15 fraud provisions, the Second Circuit "decline[d] to graft the *Dirks* personal-benefit test onto the elements of Title 18 securities fraud."[18]

The *Blaszczak* defendants argued that by not requiring the Title 15 personal-benefit test for the Title 18 fraud statutes, prosecutors would have an easier path to securing insider trading convictions, particularly under Section 1348 (which does not contain wire fraud's use-of-wires element).[19] The majority dismissed this concern, noting that "Congress was certainly authorized to enact a broader securities fraud provision, and it is not the place of courts to check that decision on policy grounds."[20] The majority added that, "[t]o the extent that the government's decision to prosecute any or all of these crimes in this case raises broader enforcement policy, that is a matter for Congress and the Executive, not the Judiciary."[21]

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14 *Id.* at 30.
15 *Id.*
16 *Id.* at 31 (internal quotations omitted).
17 *Id.* (internal quotations omitted).
18 *Id.* at 32.
19 *Id.*
20 *Id.*
21 *Id.* at 55.

In a dissenting opinion, Judge Amalya Kearse did not address the personal-benefit test. Rather, Judge Kearse challenged the majority's holding that confidential government information qualified as "property" for purposes of the Title 18 fraud statutes. She also disagreed that confidential information constituted a "thing of value" under the conversion of government property statute. Judge Kearse emphasized CMS's role as a government agency, noting that it was not in competition with other entities, that it did not solicit buyers or subscribers, and that its interest in its information was regulatory rather than proprietary or economic. CMS could fulfill its regulatory function regardless of whether its information remained confidential. For instance, CMS could always deviate from its planned adoptions of regulations even when information it desired to keep confidential was leaked prematurely.[22] Because, Judge Kearse reasoned, CMS's regulatory information did not qualify as property within the meaning of the Title 18 fraud statutes, nor as a "thing of value" stolen from CMS in violation of the conversion of government property statute, the defendants' substantive convictions should have been reversed.[23]

IMPLICATIONS & CONCLUSION

The Second Circuit's ruling in *Blaszczak* will likely embolden federal prosecutors looking to charge individuals with insider trading conduct as wire fraud and Title 18 securities fraud, thereby skirting some of the more onerous requirements of proving insider trading under Title 15. A prosecutor, citing *Blaszczak*, could allege a Title 18 scheme to defraud against a tippee without having to establish that a tipper gained a personal benefit or that the tippee was aware of a personal benefit. Because the Second Circuit refused to extend the personal-benefit test to Title 18, it is now, in some ways, easier for prosecutors to prove a criminal case for insider trading under Title 18 than it would be for the SEC to succeed in a civil case under Rule 10b-5. Furthermore, the Second Circuit's affirmance of the *Blaszczak* defendants' convictions will likely have an adverse effect on the political intelligence industry and should give pause to investment advisors, hedge funds, and other entities who currently utilize such services.

Because this theory of prosecuting insider trading cases is largely an issue of first impression, and given Judge Kearse's dissent, it is likely that the *Blaszczak* defendants will petition the Second Circuit for a rehearing en banc and seek certiorari from the Supreme Court if necessary. Nonetheless, in the wake of *Blaszczak*, investment advisors must continue to be vigilant to ensure that they do not receive confidential information, regardless of whether: (1) the confidential information relates to company information or *government* decisions; or (2) the investment advisor and its employees have any knowledge of whether the information was obtained in violation of a duty or in exchange for a personal benefit.

Investment advisors should view *Blaszczak* as a cautionary tale and use this ruling as an opportunity to reassess the use of political intelligence and other similar research firms, as the risks associated with using information generated from

22 *See United States v. Blaszczak*, Nos. 18-2811, 18-2825, 18-2867, 18-2878, slip op. at 3-7 (2d Cir. Dec. 30, 2019) (Kearse, J. dissenting).

23 *Id.* at 7.

these firms are now substantially greater than previously perceived. Moreover, *Blaszczak* confirms that the Second Circuit is willing to uphold novel constructions of criminal statutes, regardless of the lack of precedent, in situations where the legislative history and statutory text do not firmly foreclose the prosecutors' theories of criminal liability.

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