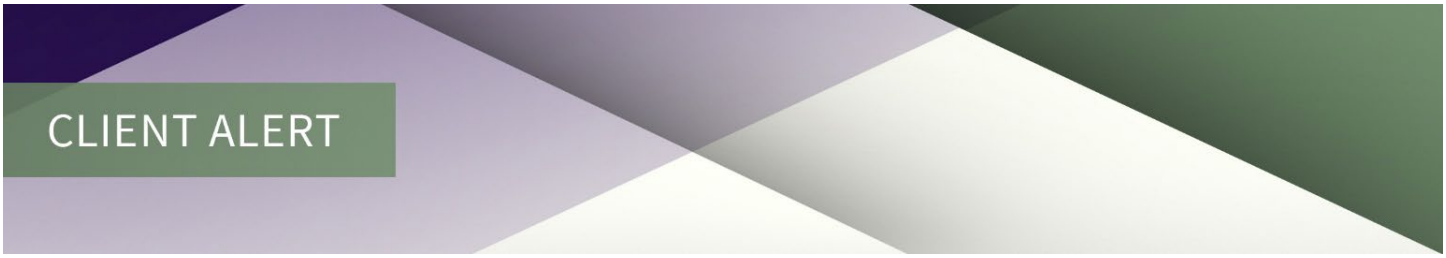

Blaszczak II: Second Circuit Judges Question Title 18 Insider Trading Liability and Confirm that "Confidential" Government Information About Regulatory Matters Does Not Constitute "Property" for Purposes of the Federal Fraud Statutes

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OVERVIEW

In recent years, prosecutors have sought to move the goal posts for insider trading prosecutions, claiming to have found an easier pathway that avoids some of the evidentiary hurdles they traditionally have had to overcome. In a rebuke, the United States Court of Appeals for the Second Circuit suggested that this prosecutorial shortcut may no longer be available. While this new decision from the Second Circuit may shrink the prosecutor's toolbox, caution must nevertheless be exercised before taking too much comfort from this development.

On December 27, 2022, the Second Circuit issued its second decision in *United States v. Blaszczak* (hereinafter "*Blaszczak* II"). Given recent Supreme Court rulings—namely, the closely followed "Bridgegate case," *Kelly v. United States*, 140 S. Ct. 1565 (2020)—the government acknowledged that the theory underlying the *Blaszczak* defendants' substantive counts

of conviction under the Title 18 fraud statutes, as well as a conspiracy conviction involving wire fraud, were no longer viable and asked the Second Circuit to remand those counts to the district court for dismissal, which the Court agreed to do. In addition, although the government argued that two remaining conspiracy convictions remained valid, the Second Circuit disagreed, vacating those counts and remanding them back to the district court for a potential retrial, should the U.S. Attorney's Office for the Southern District of New York wish to prosecute those charges further.

The decision in *Blaszczak* II offers some—albeit limited—comfort to firms looking to utilize "political intelligence" consultants and raises important questions regarding whether insider trading can be prosecuted criminally on the basis of less proof than is required to establish a civil violation of the securities fraud statutes.

HISTORY OF THE CASE

The prosecution against the *Blaszczak* defendants was the result of information allegedly passed from a political intelligence consultant, who, according to the prosecution, had been informed by an employee of the Centers for Medicare & Medicaid Services ("CMS") of changes to the reimbursement rates paid by CMS and provided with information concerning the timing of when those new rates would be publicly released. Prosecutors claimed that the *Blaszczak* defendants traded on that information and an indictment was issued, alleging that defendants had engaged in insider trading in violation of the Title 15 securities fraud statutes. In addition, prosecutors tacked on a number of additional (and somewhat novel) claims, alleging that the defendants' conduct also constituted wire fraud, conversion of government property, and securities fraud under the rarely used 18 U.S.C. § 1348 ("Section 1348"), as well as conspiracy to commit the same. To bring these additional charges, prosecutors depended upon an argument that CMS's "confidential information" (namely, the new reimbursement rates and the information concerning the timing of their disclosure) constituted government "property." Furthermore, prosecutors argued (and the district court agreed) that, under Section 1348, the government could obtain a conviction for insider trading without having to prove that the tipper at CMS received a "personal benefit," which, in traditional insider trading cases brought under Title 15, is an element that must be established in order to find a defendant guilty. At trial, the jury acquitted the defendants of securities fraud under Title 15, but found them guilty under some of the Title 18 fraud counts. In 2018, the defendants appealed their convictions to the Second Circuit, which, in a divided opinion issued in December 2019, upheld the jury's verdict.[1]

[1] The first *Blaszczak* opinion was decided on December 30, 2019, in a 2-1 decision before Judge Christopher F. Droney, Judge Richard J. Sullivan, and Judge Amalya L. Kearse (dissenting), *United States v. Blaszczak*, 947 F.3d 19 (2d Cir. 2019) (hereinafter "*Blaszczak* I"). The Second Circuit's ruling in *Blaszczak* I, along with Willkie Farr's analysis of that decision, can be accessed here. While the defendants were appealing *Blaszczak* I, the Supreme Court issued its ruling in Kelly v. United States in May 2020. In January 2021, the Supreme Court vacated and remanded *Blaszczak* I for further consideration by the Second Circuit in light of *Kelly*. *Blaszczak v. United States*, 141 S. Ct. 1040 (Mem) (Jan. 11, 2021). *Blaszczak* II was similarly decided by a 2-1 panel, with Judge John M. Walker, Jr.—who replaced Judge Droney following his retirement—joining Judge Kearse's majority opinion, while Judge Sullivan dissented. Judge Walker filed a concurring opinion to address insider trading's personal benefit test, which Judge Kearse also joined. *United States v. Blaszczak*, Nos. 18-2811, 18-2825, 18-2867, 18-2878, slip op. (2d Cir. Dec. 27, 2022). A PDF of the opinion in *Blaszczak* II, including Judge Walker's concurrence and Judge Sullivan's dissent, can be accessed here.

However, in the months following the Second Circuit's affirmance in *Blaszczak* I, the Supreme Court issued its ruling in *Kelly*, the Bridgegate case, where it reversed the defendants' wire fraud convictions on the basis that what they had interfered with—the Port Authority's right to control the alignment of the lanes on the George Washington Bridge—was not "property." Because a conviction for wire fraud requires the government to prove the defendant schemed to obtain "property" from the victim, the convictions of the Bridgegate defendants could not stand. Upon issuance of *Kelly*, the *Blaszczak* defendants immediately argued that its holding applied to their case and mandated the reversal of their convictions. The defendants argued that if the Port Authority's right to control the lanes of the George Washington Bridge did not constitute "property," neither would information concerning the timing of CMS's changes to its reimbursement rates.

The Solicitor General's office did not dispute *Kelly's* import to *Blaszczak*. Accepting the Solicitor General's position, the Supreme Court granted the *Blaszczak* defendants' writs of certiorari, vacated the *Blaszczak* I decision, and remanded the case back to the Second Circuit for further consideration in light of *Kelly*, setting the stage for *Blaszczak* II.[2]

BLASZCZAK II

A. The Meaning of "Property" Under the Title 18 Fraud Statutes

On remand back to the Second Circuit, the U.S. Attorney's Office for the Southern District of New York conceded, at the direction of the Solicitor General's Office, that its theory that CMS's confidential information regarding changes to its reimbursement rates and the timing of their public disclosure does not qualify as "property," "money," or "a thing of value" for purposes of the wire fraud statute (18 U.S.C. § 1343), conversion of government property (18 U.S.C. § 641), or securities fraud under Section 1348 ("Title 18 securities fraud"). Accordingly, the government asked for those counts to be remanded to the district court for dismissal.[3] Based on the *Kelly* decision and the prosecutorial discretion afforded to the executive branch, the Second Circuit in *Blaszczak* II granted the government's request to remand the case to the district court for dismissal of those counts.[4]

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2 *Blaszczak v. United States*, 141 S. Ct. 1040 (Mem) (Jan. 11, 2021).

3 *Blaszczak* II, slip op. at 12–13.

4 *See id.* at 15–16. *Blaszczak* II also addressed two remaining conspiracy convictions: (1) Count 1, which included conspiracy in violation of 18 U.S.C. § 371, conspiracy to convert government property, conspiracy to commit Title 15 securities fraud, and conspiracy to defraud the United States; and (2) Count 17, which was only brought against David Blaszczak, and included conspiracy in violation of 18 U.S.C. § 371, conspiracy to convert government property, and conspiracy to defraud the United States. *Id.* at 32–33. The *Blaszczak* II Court ultimately refused to reverse the conspiracy convictions, noting that both Counts 1 and 17 alleged conspiracies to defraud the United States, while Count 1 included an additional objective of committing Title 15 securities fraud, none of which were tainted by the errors admitted to by the government. Additionally, the Second Circuit observed that the "record contained sufficient evidence for submission of these counts to the jury." *Id.* at 35. As a result, the Second Circuit vacated the convictions on Counts 1 and 17 and remanded the conspiracy cases to the district court "for such further proceedings as may be necessary on these counts, which may include a new trial." *Id.* Therefore, there is still potential for the three *Blaszczak* defendants to face a new trial on the surviving conspiracy counts.

In terms of its immediate impact, *Blaszczak* II may impact prosecutions involving confidential government information, such as *United States v. Middendorf*, which involves the alleged sharing of confidential audit lists prepared by the Public Company Accounting Oversight Board with employees of an accounting firm.[5] Its implications for the longer term remain uncertain. *Blaszczak* II's ruling that confidential government information does not necessarily constitute "property" or "a thing of value" may lead to an expansion of the political intelligence industry and further liberate the exchange of information between government agencies and outside analysts. But firms should be aware that *Blaszczak* II does not provide *carte blanche* freedom to trade on confidential government information, and the case will not be interpreted by prosecutors as a categorical finding that confidential government information never qualifies as property or a thing of value under Title 18's fraud statutes. Instead, prosecutors are likely to argue that the nature of the confidential information matters. While information that implicates an agency's "regulatory" functions likely would fall within *Blaszczak* II's holding concerning information that does not constitute "property," it is a fair bet that prosecutors will argue that information that can be categorized as having an "inherent value" to the government agency may still serve as fodder for criminal prosecution under the Title 18 fraud statutes. In making such an argument, prosecutors will rely on the effort made by the majority in *Blaszczak* II to reconcile its ruling with *United States v. Girard*, 601 F.2d 69, 71 (2d Cir. 1979), which held that the DEA's confidential information concerning informants qualified as a thing of value under 18 U.S.C. § 641 (conversion of government property). *Blaszczak* II stressed the "inherent value" that the confidential information in *Girard* had to the DEA in terms of its investigations and preparations for prosecutions, noting that theft of the information would undermine the DEA's operations and potentially imperil the well-being of undercover agents and informants.[6] Given this discussion, it will be unsurprising if future prosecutors maintain that confidential information of government agencies, particularly those agencies involved in law enforcement or national security, falls outside the holding in *Blaszczak* II and qualifies as a thing of value that could be converted.

Moreover, it would be reckless to interpret *Blaszczak* II as a judicial stamp of approval for trading based on confidential government information—even where that information is "regulatory" in nature. Federal prosecutors will certainly argue that the "property" analysis at issue in *Blaszczak* II does not provide any limit on prosecutions for securities violations under Title 15, meaning that individuals who trade based on confidential government information—of any nature—run the risk of attracting charges for insider trading under Title 15.

Additionally, *Blaszczak* II does not disturb the long-held principle that trading on ***a private company's*** confidential information may constitute insider trading, punishable under either Title 15 or under Section 1348 of Title 18. *Blaszczak* II took pains to distinguish its analysis from the facts at issue in *Carpenter v. United States*, 484 U.S. 19 (1987), which involved a defendant who had traded on confidential information of *The Wall Street Journal* and was convicted on mail and wire fraud charges as well as securities fraud violations. As the Second Circuit in *Blaszczak* II explained, *The Wall Street Journal*'s confidential information qualified as the paper's "stock in trade," which was "to be distributed and sold to those who [would]

[5] On February 16, 2021, the Second Circuit stayed proceedings in *Middendorf* pending resolution of *Blaszczak* on remand.

[6] *Blaszczak* II, slip op. at 31.

pay money for it."[7] Misappropriation or premature disclosure of such confidential information would have impacted *The Wall Street Journal*'s bottom line, and thus, such confidential information constituted the newspaper's "property." By contrast, *Blaszczak* II noted, CMS was not a commercial entity; it did not "sell, or offer for sale, a service or product."[8] Disclosure of the CMS confidential information, moreover, would not have directly impacted the federal government's fisc.[9] Thus, in considering the reach of *Blaszczak* II, it is important to recognize that federal prosecutors will likely seek to limit its application to its most narrow confines and will almost certainly take the view that it has no import in cases involving confidential information obtained from the private sector.

B. The "Personal Benefit" Requirement in Insider Trading Cases

Given that the defendants' convictions for Title 18 securities fraud were found invalid on the basis of the "property" issue, the majority in *Blaszczak* II did not address one of the most controversial elements of the *Blaszczak* prosecution, namely, the government's claim that it may obtain a conviction for insider trading under Section 1348 of Title 18 without having to prove a personal benefit to the tipper, an element that is required in traditional insider trading cases brought under Title 15. Both the district court in the Southern District of New York, and the Second Circuit panel that had decided *Blaszczak* I, had agreed with the government's interpretation of Section 1348 and held that no "personal benefit" test was required.

In *Blaszczak* II, however, Judge Walker, joined by Judge Kearse, wrote a powerful concurrence to "highlight a glaring anomaly" created by the *Blaszczak* I decision.[10] As Judge Walker explained, *Blaszczak* I's decision to not impose the personal benefit test on Title 18 securities fraud prosecutions created a problematic scenario whereby the SEC, which can only bring civil enforcement actions, faced a higher burden than Justice Department prosecutors seeking a criminal conviction for insider trading under Title 18. Noting this "asymmetry," Judge Walker cautioned that "traditional notions of fair play are offended" by an "incongruence in this circuit between civil and criminal deterrence. It should not require fewer elements to prove a criminal conviction than to impose civil penalties for the same conduct."[11]

As Judge Walker further explained, the personal benefit test is the "touchstone" in insider trading cases in determining whether a tipper in fact breached her fiduciary duty by engaging in self-dealing and in determining whether a tippee was in fact aware that such self-dealing had occurred and could therefore be held derivatively liable.[12] Without the personal benefit test, Judge Walker cautioned, there is no "legal distinction between those who gave and obtained tips fraudulently and those

7 *Id.* at 29 (quoting *Carpenter*, 484 U.S. at 26 (internal quotations omitted) (emphasis removed)).

8 *Id.* at 30.

9 *Id.*

10 *Blaszczak* II, 2022 WL 17926047, at *16 (Walker, J., concurring). In his dissent, Judge Sullivan criticized Judge Walker's concurrence as dicta and an advisory opinion. *Blaszczak* II, 2022 WL 17926047, at *17 (Sullivan, J., dissenting).

11 *Blaszczak* II, 2022 WL 17926047, at *13 (Walker, J., concurring).

12 *Id.* at *14.

who appropriately engaged in the honest disclosure and collection of corporate information."[13] The self-dealing requirement of the personal benefit test functions as the line in the sand, providing notice to "corporate insiders and analysts" as to when their conduct may risk criminal exposure.[14] Practically, in the absence of the personal benefit test, corporate insiders may be "more reticent to share information with analysts in the ordinary course of business and analysts who do receive company information may be less likely to act on it for fear of running afoul of § 1348."[15] Judge Walker, therefore, implored Congress and the courts to focus their attention on the personal benefit test and its relationship to insider trading under the Title 18 securities fraud statute.[16]

Given Judge Walker's concurrence, the question of whether the personal benefit test applies to insider trading prosecutions brought under Section 1348 appears unresolved. While *Blaszczak* I found that the personal benefit test is a judge-made creation focused on the Securities and Exchange Act of 1934 and thus should not be engrafted onto Section 1348, that decision has now been vacated by the Supreme Court. Judge Walker's concurrence in *Blaszczak* II identifies a host of meaningful, and practical, problems associated with the lack of a personal benefit test, including the perverse situation wherein it is easier for the Justice Department to criminally prosecute a defendant for insider trading under Section 1348 than for the SEC to civilly pursue an individual for the same offense.

Based on the procedural posture described above, it is unclear how courts in the Second Circuit will proceed. Courts outside the Second Circuit have been more amenable to the position adopted by the government in *Blaszczak* I—that the personal benefit test does not apply to insider trading under Title 18 securities fraud and that the Title 18 securities fraud statute was meant to broaden the government's enforcement powers. Indeed, this theory pre-dates *Blaszczak* and has been accepted by federal courts in the Northern District of Georgia.[17] At least one district court in Pennsylvania has cited *Blaszczak* I in arguing that the personal benefit test does not extend to Title 18 securities fraud.[18] Other appellate courts have similarly embraced the position that the Title 18 fraud statutes afford broader enforcement power to counter schemes to defraud.[19]

Based on the lack of clarity, and given the prominent role courts in the Second Circuit play in setting the parameters for insider trading prosecutions and similar white-collar offenses, Congress and the federal judiciary should take to heart Judge

13 *Id.* at *15.

14 *Id.*

15 *Id.*

16 *Id.* at *16.

17 *See United States v. Melvin*, 2015 WL 7116737, at *8–9 (N.D. Ga. May 27, 2015), *report and recommendation adopted*, 143 F. Supp. 3d 1354 (N.D. Ga. 2015), aff'd, 918 F.3d 1296 (11th Cir. 2017); *United States v. Slawson*, 2014 WL 5804191, at *6 (N.D. Ga. Nov. 7, 2014), *report and recommendation adopted*, 2014 WL 6990307 (N.D. Ga. Dec. 10, 2014).

18 *See United States v. Ramsey*, 565 F. Supp. 3d 641, 643–46 (E.D. Pa. 2021).

19 *See United States v. Hussain*, 972 F.3d 1138, 1146 (9th Cir. 2020) (Section 1348 was "'intended to provide prosecutors with a different—and broader—enforcement mechanism to address securities fraud than what had been previously provided.'") (quoting *Blaszczak* I, 947 F.3d at 36); United States v. Jonas, 824 F. App'x 224, 231 (5th Cir. 2020) ("And a scheme to defraud [under the wire fraud statute] does not need to involve a personal benefit for the perpetrator.").

Walker's call to action in his *Blaszczak* II concurrence and offer guidance on the personal benefit test and its applicability to insider trading prosecutions under Title 18.[20] Until such clarity is provided by legislators or the courts, investment advisors should treat *Blaszczak* as a cautionary tale and use this ruling as an opportunity to reassess their compliance policies against insider trading as well as their use of political intelligence and other similar research firms.

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[20] In April 2021, Representative James Himes (D-CT) introduced H.R. 2655, the "Insider Trading Prohibition Act," which purports to codify the current law on insider trading as articulated by the courts. In May 2021, the House of Representatives passed the bill with bipartisan support, and it has since been referred to the Senate Committee on Banking, Housing, and Urban Affairs. If passed, the bill would prohibit securities trading, as well as related communications to others, by a person aware of MNPI. The bill further provides, for purposes of establishing a violation, that it is unnecessary for such a person to know specifically how such MNPI was obtained or whether a personal benefit was paid or promised.