Updates
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Second Circuit Provides Easier Path for Criminal Insider Trading Cases

The U.S. Court of Appeals for the Second Circuit issued an opinion in *United States v. Blaszczak*[1] on December 30, 2019 that could significantly affect the prosecution of criminal insider trading cases. The Second Circuit decision held that an insider-trading case brought pursuant to certain federal criminal statutes does not require the government to prove that the insider providing confidential information received a personal benefit—a departure from established insider trading caselaw interpreting securities fraud under the Securities Exchange Act of 1934.

Background

In March 2018, the U.S. Department of Justice (DOJ) charged David Blaszczak, along with two hedge fund employees and a representative of the Centers for Medicare and Medicaid Services (CMS), with securities fraud. The charges were made in connection with several insider trading schemes to obtain confidential, non-public information regarding future CMS rule-making. Blaszczak, a former CMS employee who at the time operated a "political intelligence" consulting firm, leveraged his network of CMS insiders to obtain information pertaining to the timing and substance of proposed CMS rule changes that would affect the reimbursement rates for certain medical treatments. Blaszczak then passed this information to his hedge fund clients, who in turn traded on the information—typically by shorting the stock of healthcare companies that would be negatively affected by the changes in CMS reimbursement rates.

In addition to charging securities fraud under Title 15 of the U.S. Code enacted pursuant to the Securities Exchange Act of 1934, the widely used statute in insider trading cases, the DOJ also charged the defendants with violating the securities fraud statute added to Title 18 under Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), among other charges. At trial in the U.S. District Court for the Southern District of New York, the district court instructed the jury that pursuant to *Dirks v. SEC*[2], a conviction on the Title 15 securities fraud count required a finding that the CMS insider tipped confidential CMS information in exchange for a "personal benefit." The court also instructed that Blaszczak and the hedge fund employees were aware that the CMS employee disclosed that information in exchange for a personal benefit. The district court, however, did not give this personal benefit instruction to the jury for the Title 18 securities fraud counts.

After a four-day trial, the jury acquitted all the defendants on the Title 15 securities fraud counts, but found certain defendants guilty of the Title 18 securities fraud charges.

The Second Circuit Opinion

On appeal before the Second Circuit, the defendants argued that the district court erred by failing to instruct the jury that *Dirks*'s personal benefit test also applied to the Title 18 charge. According to the defendants, there is no distinction between the elements of insider trading fraud, whether or not the charge is based on Title 18 or Title 15.

Rejecting this argument, the Second Circuit noted that while the Title 15 and Title 18 fraud provisions are similar both textually and substantively, Title 15's personal benefit test is a "judge-made doctrine premised on the Exchange Act's statutory purpose." On the other hand, within the context of the embezzlement theory of fraud underpinning Title 18, there is no additional requirement that an insider receive a personal benefit. The

Second Circuit also cited to the legislative history of the Title 18 securities fraud provisions implemented under Sarbanes-Oxley, which demonstrated congressional intent to provide prosecutors with a "different - and broader - enforcement mechanism to address securities fraud" than that provided under Title 15. Given these differences, the Second Circuit declined to "graft" the *Dirks* personal benefit requirement of Title 15 securities fraud onto Title 18.

The defendants also argued that a government agency's confidential information, such as that shared by the CMS employee, does not constitute "property" for the purposes of the Title 18 securities fraud statute. From the defendants' perspective, the term "property" implies the existence of an actual monetary or economic loss. The court also rejected this reasoning, as plain language of the Title 18 provision does not require such economic loss, but that even if such a requirement existed, CMS "*does* have an economic interest in its confidential predecisional information," as evidenced by the time and resources it invests in preserving its confidentiality. The court therefore held that "confidential government information may constitute government 'property' for purposes of" the Title 18 securities fraud provision.

Implications of *Blaszczak*

The *Blaszczak* opinion may result in the expanded use of Title 18 as a tool to prosecute criminal insider-trading schemes. Indeed, defendants argued to the Second Circuit that, from a policy standpoint, the application of the personal benefits test to Title 15 securities fraud but not to Title 18 means that prosecutors could avoid Title 15 prosecutions altogether. While the Second Circuit refused to scrutinize "such policy considerations," it is likely that the title 18 securities fraud provision will provide an additional statutory basis to prosecute insider trading in tandem with its Title 15 counterpart, particularly when the personal benefit test—the elements of which continue to be altered by case-law—proves to be a difficult burden to meet.

In this respect, a series of insider-trading cases over the past five years in the Second Circuit, the Ninth Circuit and the U.S. Supreme Court have created some uncertainty concerning the definition of a "personal benefit."[3] In *Dirks*, the Supreme Court ruled that a personal benefit includes both tangible (*e.g.*, money) and intangible (*e.g.*, friendship) benefits. In 2014, the Second Circuit limited the scope of a personal benefit by requiring "at least a potential gain of a *pecuniary* or similarly valuable nature,"[4] a conclusion which the Supreme Court later held in *Salman* to be inconsistent with intangible gift-giving prohibited under *Dirks*. Since then, other cases have struggled to clarify the scope of a personal benefit.[5]

Given the uncertainty regarding what constitutes a personal benefit, the sidestepping of that issue altogether by the Title 18 fraud provision presents a heightened risk for companies that use or rely on information from sources inside the U.S. government, including political intelligence firms. In those cases, information may be passed along with no expectation or receipt of personal gain by the tipper—which appears to have occurred in the *Blaszczak* case and other instances of alleged insider trading involving the political intelligence industry.[6] As *Blaszczak* demonstrates, the receipt of confidential government information—deemed to be "property" by the Second Circuit for the purposes of Title 18—by such firms often lacks a corresponding personal benefit to the tipper. Firms must therefore be vigilant regarding the commercial use of information obtained from government sources and take appropriate compliance measures to ensure such information is handled lawfully.

Significantly, the use of the Title 18 fraud provision to charge insider-trading cases is limited to criminal cases. The Second Circuit decision has no impact on SEC insider trading enforcement. The SEC, a civil agency, will still have to establish the personal benefit element.

ENDNOTES

[1] 2019 WL 7289753 (2d Cir. Dec. 30, 2019).

[2] 463 U.S. 646 (1983).

[3] *See e.g., United States v. Newman*, 773 F.3d 438 (2d Cir. 2014); *Salman v. United States*, 137 S. Ct. 420 (2016).

[4] *Newman*, 773 F.3d at 452.

[5] *See, e.g., United States v. Martoma*, 894 F.3d 64 (2d Cir. 2017) (amended Jun. 25, 2018) (effectively changing the test from being a requirement of a personal benefit to the *tipper* to a personal benefit to the *tippee*); *Gupta v. United States*, No. 15-2707, 2019 WL 165930 (2d Cir. Jan. 11, 2019) (rejecting *Newman*'s holding that a personal benefit requires proof of a tipper's pecuniary or other tangible gain).

[6] *See, e.g., In the Matter of Marwood Group Research, LLC*, SEC Exch. Act Rel. No. 76512 (Nov.24, 2015) (order against a political intelligence firm involving its employees' "relationships with government employees" that "created a substantial risk for MNPI to be obtained and misused[.]"); Julie Creswell, *Tip on Medicare Spurs Insider Trading Investigation*, N.Y. Times (Nov. 14, 2014), https://www.nytimes.com/2014/11/15/business/tip-on-medicare-spurs-insider-trading-investigation.html.

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