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Second Circuit Denies Rehearing in Key Insider Trading Case

On April 10, 2020, the United States Court of Appeals for the Second Circuit denied the defendants' petition for rehearing or rehearing *en banc* in *United States* v. *Blaszczak*, a key insider trading decision issued by the Court at the end of 2019. In *Blaszczak,* the Court affirmed (in a 2-1 decision) the guilty verdicts of four defendants convicted for their roles in an alleged insider trading scheme involving a hedge fund's use of political intelligence.

Now that the rehearing petition has been denied, absent a grant of certiorari by the United States Supreme Court, the law of the Second Circuit firmly establishes broad potential criminal liability for insider trading—regardless of whether the original "tipper" received a personal benefit in exchange for disclosing the information—and creates an unusual situation whereby there may be broader criminal liability than civil liability for the same conduct. Given the significance of the Court's decision and its potential impact on insider trading jurisprudence, it seems likely that the defendants will seek review of the decision from the Supreme Court.

Background

In *Blaszczak*, the United States Department of Justice alleged that an employee of Centers for Medicare & Medicaid Services ("CMS") disclosed non-public information about the timing and substance of CMS's planned changes to its reimbursement rates for certain medical treatments to David Blaszczak, a former CMS employee who worked as a political intelligence consultant for hedge funds. Blaszczak allegedly provided the non-public information to two analysts at hedge fund Deerfield Management Company, L.P., which then shorted the stock of Varian Medical Systems, a healthcare company that likely would be adversely impacted by the as-planned reimbursement rate changes. After the rate change was announced publicly, Varian's stock price fell, resulting in trading profits of approximately $3 million.

The government charged Blaszczak, the two Deerfield analysts, and the CMS employee with wire fraud, conversion of government property, securities fraud under Title 18 of the United States Code, and securities fraud under Title 15. On the government's theory, the CMS employee misappropriated and leaked to Blaszczak confidential information about upcoming, but not yet announced, reimbursement rate decisions.

At trial, the district court instructed the jury, pursuant to the seminal Supreme Court case *Dirks* v. *SEC*, 463 U.S. 646 (1983), that in order to convict the defendants of securities fraud under Title 15 of the United States Code, it needed to find that the CMS employee disclosed confidential information in exchange for a "personal benefit." The court declined, however, to give a similar "personal benefit" instruction on the

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charge of securities fraud under Title 18. The jury returned a split verdict that acquitted all defendants on the Title 15 securities fraud counts (as to which the government was required to prove a personal benefit), but found the defendants guilty of Title 18 securities fraud, conversion of government property, and wire fraud.[1]

On appeal, the defendants sought reversal on two primary grounds. First, they argued that a government agency's confidential information does not constitute "property," as required under the wire fraud, conversion, and securities fraud statutes, because the agency has a "purely regulatory" interest in such information, not an economic interest. Second, the defendants argued that the district court's instructions to the jury were erroneous because they did not require the government to prove a personal benefit under the Title 18 securities fraud (and wire fraud) counts. By a 2-1 majority, the Court rejected both arguments.

On February 3, 2020, the defendants filed a petition for panel rehearing or rehearing *en banc*. On April 10, 2020, the Court denied that petition.

Government Property

The question of whether the CMS information constituted property was critical because each of the statutes at issue required the government to prove that the government was deprived of some form of property. In particular, wire fraud prohibits schemes to obtain money or "property;" conversion of government property prohibits the conversion of any "thing of value;" and the misappropriation theory of insider trading is premised on the misappropriation of a party's property interest in confidential information.

Guided by two Supreme Court precedents demarcating the boundaries of proprietary interest—*Carpenter* and *Cleveland*—the Second Circuit held that the confidential information regarding contemplated regulatory action constituted "property." *See United States* v. *Blaszczak*, 947 F.3d 19, 34 (2d Cir. 2019). The Court reasoned that CMS possesses a "right to exclude" that is comparable to the property right recognized by the Supreme Court in *Carpenter* v. *United States*, 484 U.S. 19 (1987), a case involving pre-publication leaks of *The Wall Street Journal*'s "Heard on the Street" column, and that there is no requirement that the government's property interest be "economic" in nature. *Blaszczak*, 947 F.3d at 33.[2]

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1 One of the defendants was also acquitted of the Title 18 securities fraud charges.

2 In *Carpenter*, the Supreme Court held that the contents of forthcoming articles in *The Wall Street Journal* column were the *Journal*'s "property" for purposes of the mail and wire fraud statutes because "[t]he Journal had a property right in keeping confidential and making exclusive use" of the information before publication. 484 U.S. 19, 26 (1987). The Court observed that "[c]onfidential business information ha[d] long been recognized as property." *Id.* (citing cases). Accordingly, the Court concluded that the *Journal* employee fraudulently misappropriated his employer's property when he knowingly disclosed the *Journal*'s confidential, pre-published information to a stockbroker who traded on it.

In her dissent, Judge Amalya Kearse argued that a planned government regulation is not property because the agency can issue a regulation that adheres to its preliminary inclination whether or not there was premature disclosure. "CMS is not a business; it does not sell, or offer for sale, a service or a product; it is a regulatory agency." *Id.* at 47 (Kearse, J., dissenting).

In their motion for rehearing, the defendants argued that regulatory information is not property because it is neither the product of commercial competition nor sold as a commodity. Quoting *Cleveland* v. *United States*, 531 U.S. 12, 21 (2000), the defendants argued that if the government's core concern is regulatory, rather than economic, the object of that concern "is not property in the government regulator's hands." Jt. Petition at 7. As the *Cleveland* Court held, the "right to exclude in [a] governing capacity is not one appropriately labeled 'property.'" *Cleveland*, 531 U.S. at 24. According to the defendants, the Second Circuit's decision creates the "disturbing consequence[]" of silencing whistleblowers and journalists who report government malfeasance for fear of prosecution for fraud and conversion. Jt. Petition at 9.

By effectively rendering any unpublished government regulatory information the potential subject of an insider trading claim, the Second Circuit's denial of rehearing heightens the risks associated with using political intelligence or other government-related information—even if that information has no obvious economic value—and empowers prosecutors to criminalize virtually any disclosure or receipt of information that the government characterizes as "confidential." Even if other elements of the insider trading statute are not met—for example, if the information is not material or there is no trading on the basis of the information—the Court's expansive definition of property could serve as the basis for fraud or conversion charges, so long as the government could credibly allege that the dissemination of such information deprives it of some intangible proprietary value.

The Personal Benefit Requirement

Although courts have grappled with the "personal benefit" requirement in insider trading cases over the last few years, it has become well established that, under Title 15 securities fraud, the government must prove that a tip was provided in exchange for a "personal benefit." In *Blaszczak*, however, the Court

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By contrast, in *Cleveland* v. *United States*, the Supreme Court held that state and municipal entities possess no such property right in their unissued licenses, such as licenses to operate video poker machines. 531 U.S. 12, 20 (2000). The Court reasoned that (1) such licenses have no inherent economic value until they are issued to private actors and (2) the state's right to control the issuance of its licenses "implicates [its] role as sovereign, not as property holder." *Id.* at 22–24. As the Supreme Court has subsequently clarified, *Cleveland* "held that a [s]tate's interest in an unissued video poker license was not 'property,' because the interest in choosing particular licensees was 'purely regulatory' and 'could not be economic.'" *Pasquantino* v. *United States*, 544 U.S. 349, 357 (2005) (brackets omitted) (quoting *Cleveland*, 531 U.S. at 22–23).

addressed a matter of first impression: whether *Dirks*' personal benefit test also applies to Title 18 fraud statutes.[3] The Court held that it does not.

In so holding, the Court explicitly rejected the defendants' argument that the term "defraud" should be construed to have the same meaning across the Title 18 fraud provisions and Section 10(b) of the Exchange Act so that the elements of insider trading are the same under each of these provisions. The majority reasoned that *Dirks*' personal benefit test is a "judge-made doctrine premised on the Exchange Act's statutory purpose," explaining that Section 10(b) of the Exchange Act was created "with the limited 'purpose of . . . eliminat[ing] [the] use of inside information for personal advantage.'" *Blaszczak*, 947 F.3d at 35 (emphasis omitted) (quoting *Dirks*, 463 U.S. at 662). By contrast, Title 18 "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." *Id.* at 36–37.

Defendants and commentators alike have questioned the *Blaszczak* Court's interpretation of *Dirks*. The referenced passage in *Dirks* actually states: "This [personal benefit] standard was identified by the SEC itself in *Cady, Roberts*: a purpose of the securities laws was to eliminate 'use of inside information for

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3 Although insider trading prosecutions have traditionally been brought under Title 15, prosecutors have occasionally turned to other statutes to prosecute insider trading, including the mail and wire fraud statutes, as well as securities fraud under 18 U.S.C. § 1348. Congress enacted Section 1348 as part of the Sarbanes-Oxley Act in response to several accounting frauds involving companies such as Enron. *See* S. Rep. 107-146, 2002 WL 863249, at *2–6 (May 6, 2002). Until Title 18 was enacted, "there [was] no specific 'securities fraud' provision in the criminal code to outlaw the breadth of schemes and artifices to defraud investors in publicly traded companies." *Id.* at *6. Rather, prosecutors had to rely on "generic mail and wire fraud charges that carry maximum penalties of up to only five years imprisonment." *Id.* Such mail and wire fraud charges required prosecutors "to carry the sometimes awkward burden of proving the use of the mail or the interstate wires to carry out the fraud." *Id.* Alternatively, prosecutors could charge willful violation of certain specific securities laws or regulations, "but such regulations often contain technical legal requirements, and proving willful violations of these complex regulations allow[ed] defendants to argue that they did not possess the requisite criminal intent." *Id.* In enacting Section 1348, Congress thus achieved several goals: it relieved prosecutors of the burden of demonstrating that corporate actors violated specific accounting and reporting rules; made clear that certain fraudulent practices could be criminal even in the absence of the purchase or sale of a security; and imposed greater penalties on fraudulent corporate behavior.

Although Title 18 may well evince a congressional intent "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," *Blaszczak*, 947 F.3d at 36–37, the text of Title 18 in no way relieves prosecutors of the burden of proving fraud. Indeed, Sections 1343 and 1348 are materially similar to the text of Rule 10b-5. *See* 18 U.S.C. § 1343 (prohibiting a "scheme or artifice to defraud"); § 1348 (same); 17 C.F.R. 240.10b-5 (same). Traditionally, trading on the basis of material, non-public information amounts to fraud only when it satisfies the elements of tipper-tippee liability outlined by *Dirks*. *See Dirks*, 463 U.S. at 663 ("[T]o determine whether the [insider's] disclosure itself deceives, manipulates, or defrauds shareholders, the initial inquiry is whether there has been a breach of duty by the insider.") (internal citations and alterations omitted).

personal advantage.'" *Dirks*, 463 U.S. at 662 (quoting *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 n.15 (1961)). The Second Circuit thus transformed *Dirks*' reference to "*a* purpose" of the securities laws generally, to "*the limited* purpose" of Title 15 fraud provisions specifically. But there is a substantial difference between "a purpose" of the securities laws and "the limited purpose" of Title 15. As the defendants argued, *Dirks* was simply noting that the personal benefit test is consistent with the Exchange Act's origins, not suggesting that the requirement implements some purpose unique to the Exchange Act that does not apply to other fraud statutes.

The denial of rehearing in *Blaszczak* creates the peculiar situation whereby an alleged insider trading scheme could result in a *criminal* conviction under Title 18 securities fraud—with no showing of a personal benefit—but be legally insufficient to support a *civil* insider trading action brought by the SEC. Moreover, by distinguishing between Title 18 and Title 15 in this way, the Court effectively eliminated the "guiding principle" that the *Dirks* Court considered "essential" for market participants "whose daily activities must be limited and instructed by the SEC's inside-trading rules." *Dirks*, 463 U.S. at 664. As the Court in *Dirks* explained, "Unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses, neither corporate insiders nor analysts can be sure when the line is crossed." *Id.* at 658 n.17. The Second Circuit's conclusion that the Title 18 and Title 15 fraud statutes should be interpreted differently eliminates the clarity that *Dirks* sought to provide.

Notably, even before the *Blaszczak* decision, some lawmakers appear to have been focused on establishing greater consistency in the insider trading laws. In December 2019, the House of Representatives passed the "Insider Trading Prohibition Act" (H.R. 2534), but some lawmakers have noted that the bill does not include an exclusivity provision which would make clear that it is the exclusive law for insider trading.[4] Such a provision would avoid the problem at the heart of *Blaszczak*, where the defendants were subject to different elements of insider trading depending on which statutes the government pursued.

By eliminating the personal benefit requirement, the Second Circuit has essentially lowered the bar for criminal insider trading prosecutions and enabled prosecutors in this Circuit to pursue charges in circumstances that previously could not have been the basis for prosecution. As the defendants argued in their rehearing petition, "[T]he decision will radically expand criminal liability by allowing prosecutors to evade the personal-benefit requirement and will throw insider-trading law—and those who rely on it to govern their conduct—into chaos." Jt. Petition at 12. The decision may also create disparities in the application of the insider trading laws across different circuits, as no other Court of Appeals has held that the elements of insider trading differ under Title 18 and Title 15.

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[4] *See generally* Press Release, Financial Services Committee Republicans, McHenry Amendment Accepted to Improve Insider Trading Bill, Protect Good Faith Traders (Dec. 5, 2019).

As a practical matter, however, the personal benefit requirement has not imposed a very high bar and the government rarely has had difficulty satisfying that element. It remains to be seen therefore whether and to what extent the decision actually emboldens prosecutors to test the limits and pursue more aggressive insider trading actions where the evidence of a personal benefit is limited or non-existent. Moreover, it seems likely that the defendants in *Blaszczak* will seek certiorari from the Supreme Court, which may provide another opportunity for the Court to more clearly delineate the boundaries of the insider trading laws.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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