Recent Developments in Charges of Insider Trading

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Editor's note: Derek A. Cohen and James Gatta are partners and Zoe Bellars is a law clerk at Goodwin Procter LLP. This post is based on their Goodwin Procter memorandum. Related research from the Program on Corporate Governance includes Insider Trading Via the Corporation by Jesse Fried (discussed on the Forum here).

In a recent decision, the Second Circuit in *United States v. Blaszczak* may have made the prosecution of insider trading significantly easier by ruling that the government is not required to prove that an insider received any "personal benefit" in exchange for sharing material, nonpublic information with a trader when the crime is charged under the wire fraud and securities fraud statutes in Title 18 of the United States Code. This ruling establishes an explicit distinction between what the government must prove to convict defendants of insider trading charges brought under Title 18 rather than those charged under the Securities Exchange Act of 1934, found in Title 15 of the United States Code (the "Exchange Act").

Since the Supreme Court's 1983 decision in *Dirks v. SEC*, federal prosecutors pursuing insider trading cases under Title 15 have had to prove that insiders received some "personal benefit" in exchange for tips that they passed to traders. Several post-*Dirks* rulings from the Second Circuit and the Supreme Court have further refined the personal benefit test, entrenching the test in Title 15 insider trading analysis. In *Blaszczak*, however, the Second Circuit specifically "decline[d] to graft the *Dirks* personal-benefit test onto the elements of Title 18 securities fraud," reasoning that, among other things, the securities fraud sections added to Title 18 as part of the Sarbanes-Oxley Act in 2002 were intended to serve as a broader enforcement mechanism than their Title 15 counterparts. This decision therefore potentially expands federal prosecutors' ability to criminally charge insider trading cases, with Title 18 charges as a different, and potentially more flexible, vehicle to pursue such conduct.

The Court's Opinion on *Blaszczak*

On December 30, 2019, the Second Circuit in *United States v. Blaszczak* held that, among other rulings, the personal benefit test in *Dirks v. SEC* does not apply to securities fraud charges brought under Title 18 and that confidential government information can constitute "property" for purposes of the wire fraud and securities fraud statutes in Title 18.

The lead defendant, David Blaszczak, had worked for the Centers for Medicare & Medicaid Services (CMS), a federal agency within the United States Department of Health and Human Services, before becoming a consultant. In that role, prosecutors alleged that Blaszczak passed along confidential predecision CMS information to employees at hedge funds focused on the healthcare industry, including information about planned changes to Medicare reimbursement

rates. Among other charges, Blaszczak, a former CMS employee, and two former hedge fund analysts to whom Blaszczak was charged with passing CMS information, were acquitted at trial in May 2018 on the Title 15 insider trading counts but nevertheless convicted under Title 18. The Second Circuit's 2-1 ruling upheld their convictions.

Personal Benefit Test

Dirks and its progeny cases firmly established a personal benefit requirement when establishing liability for insider trading under Title 15. In *Dirks*, the Supreme Court explained that a tippee's liability for insider trading turns on whether the tipper breached a fiduciary duty by sharing material, non-public information, which occurs when the tipper disclosed the inside information for a personal benefit. The benefit can often be inferred from "objective facts and circumstances"—including "when an insider makes a gift of confidential information to a trading relative or a friend." The *Dirks* Court explained that, in such circumstances where the tip is provided to a trading relative or friend, the jury can infer that the tipper meant to provide the equivalent of a cash gift.

Since then, there have been a number of cases further refining the requisite proof of a personal benefit, including the Second Circuit's decision in *United States v. Newman* that a factfinder cannot infer a personal benefit in *Dirks'*s gift-giving scenario unless there is "proof of a meaningfully close personal relationship" between the tipper and tippee "that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." Later, in *Salman v. United States*, the Supreme Court refused to extend *Newman*'s requirement that the tipper must also receive something of a "pecuniary or similarly valuable nature" where there is no proof of "close" friendship or family relationship, but found that *Dirks* permits an inference of personal benefit where the tipper gifts information to a "trading relative or friend."

In *Blaszczak*, the Second Circuit rejected the argument that *Dirks* applies to Title 18, instead describing the personal benefit test as a "judge-made doctrine premised on the Exchange Act's statutory purpose" that was developed specifically with the prescripts of Title 15 in mind. The Court noted that while "Title 18 fraud statutes and Title 15 fraud provisions share similar text and proscribe similar theories of fraud," Title 15 was enacted to eliminate the use of inside information for personal advantage, whereas Title 18 was enacted with a broader enforcement purpose in mind. Specifically, Title 18 was intended to "supplement the patchwork of existing technical securities law violations with a more general and less technical provision," providing prosecutors with a "different—and broader—enforcement mechanism to address securities fraud than what had been previously provided in the Title 15 fraud provisions." Because of these differences in congressional intent, the Court reasoned that the elements required to establish insider trading liability under Title 15 are also necessarily different from the elements required to establish insider trading liability under Title 18.[1] Therefore, the Second Circuit declined "to graft the *Dirks* personal-benefit test onto the elements of Title 18 securities fraud." In doing so, the court specifically rejected the defendants' policy-based argument that by not extending *Dirks* beyond Title 15, the

[1] The wire and securities fraud statutes in Title 18 prohibit the embezzlement or fraudulent conversion of property, in this case the confidential CMS information. *Blaszczak* makes clear that to secure an insider trading conviction under Title 18 securities fraud, the government must prove that the defendant engaged in a scheme to embezzle or convert inside information and transfer it to his own use or the use of someone else, in connection with the purchase or sale of a registered security. Title 18 does not require additional proof that the insider breached a duty to the property's owner, the Second Circuit reasoned, as it is "impossible" for a defendant to embezzle or misappropriate property "without committing a fraud upon him."

“government may avoid the personal-benefit test altogether by prosecuting insider trading with less difficulty under the Title 18 fraud statutes—particularly the Title 18 securities fraud statute.”

To what extent this ruling will change how the government charges insider trading obviously remains to be seen. For the time being, it is likely that government may follow the approach employed by the prosecutors in *Blaszczak* and utilize both statutes to charge the same conduct. Without the need to prove a personal benefit to an insider though, the government may be able to charge certain insider trading cases that it previously could not.

Meaning of “Property” Under Title 18

Significantly, the *Blaszczak* court also held that the confidential CMS information at issue was considered “property” under the wire fraud and securities fraud statutes in Title 18. Construing “property” in accordance with its common meaning (a thing of value in the possession of the property holder), the Second Circuit found that CMS had a proprietary right, that existed beyond CMS’s regulatory interests, to keep its nonpublic pre-decision information confidential and to exclude other use of the information; this right to exclude the public from accessing the information “squarely implicates the government’s role as property holder.” The Second Circuit also cited CMS’s economic proprietary interest in making efficient use of the agency’s limited resources and time as support for this finding, while noting that the economic value of “property” need not be monetary in nature. Notably, Judge Kearse filed a dissent in *Blaszczak* on the grounds that CMS is “not a business” and that the agency’s predecisional regulatory information is not its “stock in trade” and therefore not “property” for purposes of a Title 18 violation, among other things. Given this divide, the question of what kinds of confidential information can be considered property in connection with an insider trading prosecution under Title 18 will be likely be one that courts and litigants will continue to grapple with.