Second Circuit Lowers the Bar for Charging Criminal Insider Trading

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On December 30, 2019, the United States Court of Appeals for the Second Circuit affirmed the convictions of four individuals charged with disclosing and trading on nonpublic government information, adding a new twist to decades of judicial precedent on the definition of insider trading. *See United States v. Blaszczak*.[1] The court held that the "personal-benefit" test for insider trading established by the Supreme Court in *Dirks v. SEC*[2] does not apply to wire and securities fraud under Title 18 of the U.S. Code. Additionally, the court held that confidential government information constitutes "property" for the purposes of federal fraud statutes. The ruling will make it easier for the government to prosecute insider trading even when there is no clear benefit to the source who provided the information.

Background

In May 2018, a jury sitting in the Southern District of New York convicted defendants David Blaszczak, Christopher Worrall, Theodore Huber, and Robert Olan on wire fraud, securities fraud, and conversion charges, pursuant to Title 18,[3] while acquitting each on insider trading charges pursuant to Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5 pursuant to Title 15.

The securities and commodities fraud provision in Section 1348 of Title 18 was adopted in 2002 as part of the Sarbanes-Oxley Act to give prosecutors a new tool for targeting individuals suspected of engaging in fraudulent practices affecting the U.S. securities and commodities markets. It was modeled on the mail and wire fraud statutes. Accordingly, the Department of Justice (DOJ) can use either Title 18 or Title 15 to criminally prosecute insider trading; the SEC can only use Title 15 (which, unlike Title 18, has both criminal and civil insider trading-related provisions).

According to the indictment, Blaszczak, a "political intelligence" consultant and former employee of the Centers for Medicare and Medicaid Services (CMS), obtained information about prospective changes to Medicare reimbursement rates from Worrall, his source at CMS. Blaszczak then tipped off Huber and Olan, analysts at a hedge fund, who traded on the information for gains of over $7 million.

In accordance with long-standing precedent, the district court instructed the jury that to convict on Title 15 securities fraud, it had to find that Worrall disclosed the information for a personal benefit that was known to the recipients of the tip. However, the court refused to give these instructions on the Title 18 wire fraud and securities fraud counts.

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[1] 2019 WL 7289753.

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

[3] *See* 18 U.S.C. §§ 1343, 1348, and 641.

Personal-Benefit Test

On appeal, the Second Circuit addressed for the first time whether the government can criminally prosecute insider trading under Title 18 without proving personal benefit to the tipper—an element imposed by the Supreme Court on Section 10(b) long before the creation of Section 1348.

Since there is no statute specifically outlawing insider trading, courts have relied on 40 years of judicial precedent to determine when trading on material nonpublic information constitutes a violation of the antifraud provision of Title 15. In *Dirks,* the Supreme Court held that to convict on Title 15 securities fraud, the government must prove the tipper breached a duty of trust and confidence by disclosing material, nonpublic information in exchange for a personal benefit.[4] The Second Circuit later added to the *Dirks* test, holding that a tippee in such cases must utilize the inside information knowing it had been obtained in breach of the insider's duty.[5] This raised the bar for insider trading prosecutions, particularly in cases in which a close connection between tipper and tippee could not be established and there is no obvious exchange of value.

The question in *Blaszczak* was whether the *Dirks* test also applies to Title 18 securities and wire fraud, and thus whether the district court erred in failing to include the personal-benefit element in its jury instructions for those counts. The defendants argued that the government could not use Title 18 to circumvent an element that courts have traditionally deemed necessary for insider trading convictions under Title 15. They claimed that since the Title 18 statutes contain similar operative language as Section 10(b) provisions and target the same conduct, they should be subject to the same requirements.

The government argued—and the court agreed—that the meaning of "defraud" in the Title 18 statutes includes the "embezzlement" theory, which involves fraudulent appropriation of someone else's property to one's own use.

The personal-benefit test, according to the Second Circuit, is tied to the purpose of the Securities Exchange Act and Title 15 securities laws, which aim to prohibit the use of inside information *for personal advantage*. In the context of embezzlement, however, there is no additional requirement of personal benefit, since the appropriation of another's property constitutes embezzlement regardless of what the embezzler does with the property. The court relied on *Carpenter v. United States*,[6] in which the Supreme Court affirmed mail and wire fraud convictions under Title 18 based on an embezzlement theory, without deciding on the Section 10(b) liability charges.

Government Information as Property

The defendants also argued on appeal that CMS's confidential information was not "property" in the hands of the government for the purposes of a scheme to defraud because CMS's interest in the information was purely regulatory.

The Second Circuit disagreed, holding that confidential government information may constitute "property" in the hands of the government. The court found that the defendants' misuse of CMS's confidential information by definition interfered with the agency's right to exclude the public from accessing the information, and that the interference was serious because it risked harming the government's interests.

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[4] 463 U.S. at 660-63 (1983).

[5] *See United States v. Newman*, 773 F.3d 438, 447-49 (2d Cir. 2014), *abrogated on other grounds by Salman v. United States*, 137 S. Ct. 420 (2016).

[6] 484 U.S. 171 (1987).

The court relied again on *Carpenter*, where a newspaper's prepublication information was deemed property for the purposes of mail and wire fraud statutes when an employee knowingly disclosed it to a stockbroker.[7]

The court distinguished *Cleveland v. United States*,[8] in which the Supreme Court held that a government license to operate poker machines was not "property" under the mail fraud statute. While the government's interest there was purely regulatory and could not be economic, CMS's interest in its predecisional regulatory information included additional elements like the right to exclude. Moreover, CMS had an economic interest in the leaked information based on the resources it devoted to generating and maintaining its confidentiality. The court further found that leaks of such information could impede the agency's efficient functioning, and that the government's interest in the information need not be monetary in nature.

Judge Amalya Kearse issued a strong dissent, arguing that CMS was not deprived of anything that could be considered property.

Implications

While historically the substantive law for criminal and civil insider trading cases has largely been the same, this ruling creates different requirements for establishing insider trading depending on whether the government pursues civil or criminal enforcement. The ruling does not apply to the SEC's civil enforcement cases as Title 18 is a criminal statute,[9] and as a result individuals may potentially face only criminal liability in certain circumstances.

The ruling allows prosecutors to circumvent the personal-benefit requirement that has long attached to insider trading prosecutions by permitting charges under Title 18 when no personal benefit to the tipper can be shown. This can be particularly useful for prosecutors when tips are passed on indirectly and without a close personal connection between the tipper and the tippee.

The Second Circuit acknowledged these enforcement policy implications but refused to consider them in its decision. The court noted that Congress has the authority to enact a broader securities fraud provision to address the issue of multiple statutes criminalizing "overlapping conduct." Until such a law is passed or the Supreme Court takes up the issue, the government can be expected to rely on Title 18 securities and wire fraud charges to target insider trading and avoid the personal-benefit requirement.

Further, this ruling may be used as support for a comprehensive insider trading statute to address the issues that have arisen in recent judicial opinions. Last month, the U.S. House of Representatives passed a bill containing one such statute, the Insider Trading Prohibition Act (ITPA), which includes language requiring a showing that nonpublic information was given for a direct or indirect personal benefit.[10] The Senate has not addressed this issue.

The Second Circuit's decision in *Blaszczak* can be found here.

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[7] *Id.* at 28.

[8] 531 U.S. 12 (2000).

[9] The SEC filed a parallel civil complaint against all of the defendants except Olan. That case remains pending. *See SEC v. David Blaszczak, et al.*, Civil Action No. 1:17-CV-03919 (S.D.N.Y., filed May 24, 2017).

[10] H.R. 2534, 116th Cong. (1st Sess. 2019).

Davis Polk

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

New York

Greg D. Andres	+1 212 450 4724	greg.andres@davispolk.com
Martine M. Beamon	+1 212 450 4262	martine.beamon@davispolk.com
Angela T. Burgess	+1 212 450 4885	angela.burgess@davispolk.com
Tatiana R. Martins	+1 212 450 4085	tatiana.martins@davispolk.com

Washington, DC

Neil H. MacBride	+1 202 962 7030	neil.macbride@davispolk.com
Fiona R. Moran	+1 202 962 7137	fiona.moran@davispolk.com
Paul J. Nathanson	+1 202 962 7055	paul.nathanson@davispolk.com
Linda Chatman Thomsen	+1 202 962 7125	linda.thomsen@davispolk.com
Kenneth L. Wainstein	+1 202 962 7141	ken.wainstein@davispolk.com

Hong Kong

Patrick S. Sinclair	+852 2533 3305	patrick.sinclair@davispolk.com