Litigation Alert

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U.S. v. Blaszczak: The 2nd Circuit Makes it Easier to Prosecute Insider Trading

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Key Points:

- The 2nd Circuit has issued a landmark decision for insider trading enforcement that will make it significantly easier for the government to prosecute insider trading in criminal cases.
- The decision may also bolster the government's recent efforts to enforce insider trading laws in relation to "political intelligence."

On December 30, 2019, the 2nd Circuit affirmed the judgments of the district court in *United States v. Blaszczak*, convicting defendants David Blaszczak, Theodore Huber, Robert Olan and Christopher Worrall of Title 18 securities fraud, wire fraud, conversion of United States property and conspiracy. No. 18-2811, 2019 WL 7289753 (2d Cir. Dec. 30, 2019). In doing so, the 2nd Circuit held that (1) the "personal benefit" test announced in *Dirks v. SEC*, 463 U.S. 646 (1983), which is an essential element of tipper-tippee insider trading under the antifraud provisions of the Securities and Exchange Act of 1934 ("Title 15 securities fraud"), does not apply when a defendant is being prosecuted for the same conduct under the wire fraud statute or as securities fraud pursuant to the Sarbanes Oxley Act of 2002 ("Title 18 securities fraud"), and (2) confidential government information may constitute "property," the misappropriation of which can provide a basis for criminal liability under the wire and Title 18 securities fraud statutes. As explained below, these holdings will likely change the landscape for insider trading enforcement, making it significantly easier for the government to prosecute insider trading in criminal cases.

On March 5, 2018, the government filed a superseding indictment in the Southern District of New York alleging that Centers for Medicare & Medicaid Services' (CMS) employees, including Worrall, disclosed the agency's confidential information regarding proposed rules and reimbursement rates to Blaszczak, a hedge fund consultant, who in turn tipped Huber and Olan, employees of a healthcare-focused hedge fund, Deerfield Management Company, L.P. Deerfield then traded on the confidential information. The government's indictment included counts for Title 15 securities fraud, wire fraud and Title 18 securities fraud as well as conversion of U.S. property and conspiracy. On May 3, 2018, the jury returned a split verdict. The jury

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acquitted all defendants of Title 15 securities fraud, but found all of the defendants, with the exception of Worrall, guilty of Title 18 securities fraud and wire fraud.

On appeal to the 2nd Circuit, the defendants sought reversal on two primary grounds. First, they argued that the district court erred by refusing to instruct the jury on the *Dirks* personal benefit test for the Title 18 wire and securities fraud counts. In *Dirks v. SEC*, the Supreme Court established the basic template for tipper-tippee liability when charged as Title 15 securities fraud, holding that: (a) a tipper is liable if he or she discloses material nonpublic information to someone in breach of a fiduciary duty and in order to receive a personal benefit; and (b) a tippee is liable if he or she knows that the tipper has disclosed inside information in breach of a duty and for a personal benefit, but nevertheless trades on the basis of the information. 463 U.S. at 659-60. In *Blaszczak*, the 2nd Circuit rejected the defendants' "personal benefit" argument and declined to extend the *Dirks* test to Title 18, explaining that the test is a "judge-made doctrine premised on the [Securities] Exchange Act's statutory purpose . . . of eliminating the use of inside information for personal advantage." *Blaszczak*, 2019 WL 7289753 at *8 (internal citations omitted). By contrast, the 2nd Circuit found that Congress intended Title 18 to provide prosecutors with a "different – and broader – enforcement" mechanism unencumbered by Title 15's "technical legal requirements," and thus the *Dirks* test was inapplicable. Id. at *9.

Second, the defendants contended that a governmental agency's confidential information is not "property" in the hands of the agency because the agency has a "purely regulatory" interest in such information. In order to prove Title 18 fraud, the government must show that defendants engaged in a scheme to defraud another of property. 18 U.S.C. §§ 1343, 1348. The 2nd Circuit disagreed, and instead found that CMS possesses a property right in confidential information under the Supreme Court's decision in *Carpenter v. United States*, 484 U.S. 19, 26 (1987), which involved insider trading charges under the mail and wire fraud statutes against a Wall Street Journal reporter who improperly disclosed confidential information about future news articles that could influence the price of the profiled companies' securities. Just as *Carpenter* found the Wall Street Journal's confidential publication schedule and contents of future articles were the newspaper's "property," the 2nd Circuit held that CMS possessed a comparable property right in its nonpublic information and it therefore qualified as "property" under Title 18.

Judge Kearse dissented from the majority's affirmance of the convictions. In particular, Judge Kearse disagreed with the majority's finding that CMS's confidential information was "property" for the purposes of Title 18 fraud. *Blaszczak*, 2019 WL 7289753 at *19. Instead, Judge Kearse viewed CMS's information as regulatory conduct akin to issuance of gaming licenses that the government had the right to control or withhold, but which had no property status until they were issued. Id. Judge Kearse therefore concluded that a premature disclosure of CMS's confidential information was not property for the purposes of Title 18 fraud.

The 2nd Circuit's decision in *Blaszczak* will likely have a significant impact on criminal insider trading prosecutions going forward. By charging fraud under Title 18 as opposed to Title 15, the criminal authorities will be able to sidestep *Dirks* and its "personal benefit" test, which the government has fought to narrow in numerous cases in recent years. However, the Securities and Exchange Commission, which does not have the authority to invoke criminal fraud statutes under Title 18, remains bound by

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Dirks in tipper-tippee cases. Second, *Blaszczak*'s definition of confidential government information as "property" for the purposes of Title 18 may bolster the government's recent efforts to enforce the insider trading laws in relation to "political intelligence," which has become an increasingly important source of research in certain sectors of the investment industry. In future cases, the 2nd Circuit's concept of "confidential" government information may conflict with the culture in Washington, D.C., where there are no established corporate disclosure rules and information is often leaked for a variety of reasons, political and otherwise.

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