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ALERT MEMORANDUM

Second Circuit: Criminal Fraud Statutes Do Not Require Prosecutors to Show that Tippers in Insider-Trading Cases Received a "Personal Benefit"

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The Second Circuit has made it easier for federal prosecutors to bring insider-trading cases. In *United States v. Blaszczak*, decided on December 30, 2019, the Court held that the personal-benefit test—a judge-made rule that the government must prove a tipper expected to receive some benefit in exchange for disclosing confidential information—does not apply to insider-trading prosecutions brought under certain federal criminal fraud statutes. The *Blaszczak* decision thus opens the door to insider-trading prosecutions where a "personal benefit" would be difficult or impossible to prove. The decision contained another notable holding: a government agency's confidential regulatory information can constitute "property," such that its misappropriation can be the basis for an insider-trading prosecution under the criminal fraud statutes. This holding—which triggered a dissent by one of the panel members—could facilitate insider-trading prosecutions involving so-called "political intelligence" consultants, like Blaszczak, who collect and analyze information concerning government agency activity that can be used in making securities trading decisions.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

NEW YORK

David E. Brodsky
+1 212 225 2910
dbrodsky@cgsh.com

Lev L. Dassin
+1 212 225 2790
ldassin@cgsh.com

Victor L. Hou
+1 212 225 2609
vhou@cgsh.com

Jonathan S. Kolodner
+1 212 225 2690
jkolodner@cgsh.com

WASHINGTON

Robin M. Bergen
+1 202 974 1514
rbergen@cgsh.com

Matthew Solomon
+1 202 974 1680
msolomon@cgsh.com

Background

No federal statute defines and prohibits insider trading. Instead, prosecutors and regulators have historically brought insider-trading cases under Section 10(b) of the Securities Exchange Act (codified in Title 15 of the United States Code)—the most widely-used antifraud provision of the federal securities laws.[1] In the Supreme Court's 1983 seminal insider-trading decision *Dirks v. SEC*, the Court held that insiders who disclose confidential corporate information breach their duty to the corporation's shareholders, and thereby violate Section 10(b), only when they act in exchange for a "personal benefit."[2] *Dirks* involved corporate insiders who leaked information to a securities analyst—Dirks—in order to expose ongoing fraud inside their company. Dirks disclosed that information to clients, who in turn traded.[3] Dirks avoided liability under Section 10(b) because the insiders did not disclose information to him in exchange for a" personal benefit."

Dirks was a civil case brought by the SEC, but courts also applied its "personal benefit" holding to criminal insider-trading cases brought by the Justice Department under Section 10(b). Following *Dirks*, to convict a corporate insider of unlawful tipping, prosecutors were required to prove that the tipper breached his duty to shareholders by disclosing material, nonpublic information in exchange for a "personal benefit."[4] And to convict a tippee, prosecutors were required to prove that the tippee knew of the tipper/insider's breach.[5]

Dirks was based on the so-called "classical" theory of insider trading, which involves a corporate insider's breach of duty to the company's shareholders. For years, courts split on whether the *Dirks* "personal benefit" test also applied to the so-called "misappropriation" theory of insider trading—which entails the theft of information in breach of a duty of confidence to the information's source (as opposed to a breach of duty to the shareholders of the corporation whose stock is being traded).[6] It is now well settled, however, that the personal-benefit test applies under both theories.[7]

In the years after *Dirks*, courts grappled with the question of what precisely constituted a "personal benefit." Many courts took an expansive view of

[1] *See, e.g.*, *Chiarella v. United States*, 445 U.S. 222, 230 (1980); *United States v. O'Hagan*, 521 U.S. 642, 643 (1997).
[2] 463 U.S. 646, 663 (1983).
[3] *Id.* at 649.
[4] *United States v. Riley*, 638 F. App'x 56, 60 (2d Cir. 2016).
[5] *United States v. Jiau*, 734 F.3d 147, 152–53 (2d Cir. 2013) (citations omitted). While prosecutors need to prove actual knowledge, the SEC need only prove that a tippee "knew or should have known." *See SEC v. Obus*, 693 F.3d 276, 287–88 (2d Cir. 2012).
[6] *See* Donald C. Langevoort, 18 Insider Trading: Regulation, Enforcement & Prevention, § 4:10 at 6-48 (2017) ("[T]here was disagreement in the lower courts about whether the *Dirks* test applies in its entirety to misappropriation cases. Some said clearly yes, while others—plainly seeing misappropriation as a 'stolen goods' prohibition—expressed doubt.").
[7] *See id.* ("In recent years, however, the law has become clearer that *Dirks* does indeed control both classical and misappropriation cases."). It was not until after the Second Circuit's decisions in *Obus*, 693 F.3d at 285–86 (holding that the personal-benefit test applies fully in misappropriation cases) and *United States v. Newman*, 773 F.3d 438, 446 (2d Cir. 2014) ("The elements of tipping liability are the same, regardless of whether the tipper's duty arises under the 'classical' or the 'misappropriation' theory." (citing *Obus*, 693 F.3d at 285–86)), as well as the Supreme Court's decision in *Salman v. United States*, 580 U.S. ___, 137 S. Ct. 420, 425 n.2 (2016) (declining to determine whether the case presented a misappropriation theory or a classical theory and instead assuming that the same tipper-tippee test applied under each theory), that it became well settled that *Dirks* applied to misappropriation cases.

what kind of benefits were sufficient to meet the test.[8] In 2014, however, the Second Circuit in *United States v. Newman* adopted a new, more rigorous standard for proving "personal benefit," requiring "an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[9] The Court also held that tippee liability required proof not only that the tippee knew of the tipper's breach, but also that he knew of the tipper's "personal benefit."[10] The government contended that these more onerous "personal benefit" standards seriously undermined its ability to prosecute insider-trading cases. Although a subsequent Supreme Court case, and several ensuing Second Circuit cases, eventually cut back on the *Newman* standard,[11] the personal-benefit test remains more of an obstacle for the government today than it was in the 31 years between *Dirks* and *Newman*.[12]

Perhaps due to the unsettled elements of an insider trading offense under Section 10(b), including the personal-benefit test, prosecutors have also used Title 18 criminal fraud statutes to prosecute insider trading, including Section 1343 (wire fraud) and Section 1348 (securities fraud). In *Blaszczak*, prosecutors did just that, charging the defendants with insider trading under both Section 10(b) and Title 18 fraud statutes.

Proceedings in the District Court and the Second Circuit's Decision

David Blaszczak worked as a "political intelligence" consultant and maintained friendships with several of his former colleagues at the Centers for Medicare & Medicaid Services ("CMS"). By speaking to his sources at CMS, Blaszczak learned of forthcoming changes in Medicare and Medicaid reimbursement rates for particular medical procedures. He shared this confidential information with hedge funds that then traded on the information before it became public, making millions of dollars.[13]

On March 5, 2018, prosecutors in the Southern District of New York brought an indictment against Blaszczak, one of his CMS sources, and two hedge fund partners, charging them with violations of Title 15, Section 10(b), as well as Title 18, Sections 1343 and 1348.[14] At trial, Judge Kaplan instructed the jury that in order to convict the defendants on the Section 10(b) charges, prosecutors had to prove that the CMS

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[8] *See, e.g., Jiau*, 734 F.3d at 153 (a jar of honey and an iPhone were a sufficient "personal benefit"); *United States v. McPhail*, 831 F.3d 1, 11 (1st Cir. 2016) (wine and a free dinner were sufficient).
[9] 773 F.3d at 452.
[10] *Id.* at 447–50.
[11] *See, e.g.*, *Salman*, 137 S. Ct. at 428 (holding that to the extent that Newman "held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends . . . this requirement is inconsistent with *Dirks*"); *United States v. Martoma*, 894 F.3d 64, 71 (2d Cir. 2017), *as amended* June 25, 2018 (holding that it "need not" reach the question of "whether *Newman*'s gloss on the gift theory is inconsistent with *Salman*"); *see also Gupta v. United States*, 913 F.3d 81, 87 (2d Cir. 2019) ("The *Newman* formulation" that a tipper must receive something of a "pecuniary or similarly valuable nature" in exchange for a gift to a friend "was expressly rejected by the Supreme Court in *Salman*[]."); *United States v. Klein*, 913 F.3d 73, 78 (2d Cir. 2019) (accord).
[12] Today to establish insider-trading liability by a tippee-trader in a criminal case, prosecutors must prove that the defendant: (i) traded in securities while (ii) in possession of material, nonpublic information that he knew was (iii) obtained as a result of a breach of duty and (iv) provided by the tipper in exchange for a personal benefit. *See Salman*, 137 S. Ct. at 427–29.
[13] *United States v. Blaszczak*, — F.3d — , No. 18-2811, 2019 WL 7289753, at *1–3 (2d Cir. Dec. 30, 2019).
[14] *Id.* at *3. The defendants were also charged with conversion of government property, in violation of Section 641 of Title 18.

employee tipped Blaszczak in exchange for a "personal benefit" and that Blaszczak and the hedge fund partners knew that a CMS insider had tipped the information in exchange for a "personal benefit." Over a defense objection, however, the Court did not give the same "personal benefit" instruction for the Title 18 wire and securities fraud offenses.[15]

The jury acquitted the defendants on the Title 15, Section 10(b) counts, but convicted them on the Title 18 criminal fraud counts.[16]

On appeal, the defendants argued that the elements of insider trading under Titles 15 and 18 should be the same, and that the district court therefore erred by refusing to instruct the jury on "personal benefit" for the Title 18 counts.[17] Judge Sullivan, writing for the panel, disagreed. The Court explained that while the Title 15 and 18 statutes both prohibit schemes to "defraud," including the "misappropriation" of confidential information, they have different statutory purposes. According to the Court, Title 15's fraud provisions were meant to eliminate the use of insider information for personal advantage, and *Dirks*' personal-benefit test was a "judge-made" rule designed to effectuate that purpose while still preserving the efficient pricing of securities by allowing a person to profit from generating market information.[18] The Court declined to extend *Dirks* beyond that particular statute.

In so doing, the Second Circuit relied on *Carpenter v. United States*, a 1987 decision in which the Supreme Court affirmed a defendant's insider-trading convictions under the Title 18 mail and wire fraud statutes, without any reference to the *Dirks* personal-benefit test.[19] And it pointed to the legislative history of Section 1348, which Congress passed in 2002 as part of the Sarbanes-Oxley Act in large part to overcome the "technical legal requirements" of the Title 15 fraud provisions.[20] The panel also rejected the defendants' "policy" argument that if the Court sided with the government, prosecutors could bring insider-trading cases with "less difficulty" under Title 18 than Title 15, noting that a court's statutory analysis should not turn on such "enforcement policy considerations," and that it is not unusual to have overlapping statutes prohibiting similar conduct.[21]

The Court's second notable holding concerned another essential element of the Title 18 fraud statutes: namely, that the defendants defrauded their victim out of "property." The defendants argued that CMS—the alleged victim—had a "purely regulatory" interest in information about its planned changes in Medicare and Medicaid reimbursement rates, and that the information was therefore not "property" for purposes of the Title 18 fraud statutes.[22] The Court's analysis of that issue was guided by two prior Supreme Court decisions: (i) *Cleveland v. United States*, which held that an unissued license in the hands of the government did not constitute "property" for purposes of a Title 18 fraud prosecution, and (ii) *Carpenter*, which held that the pre-publication

[15] *Id.* at *4.
[16] *Id.* The defendants were also convicted under Section 641. The CMS employee—Worrall—was acquitted on the Title 18 securities fraud charge, but convicted on wire fraud and Section 641 charges.
[17] *Id.* at *5–9. Defendants also appealed their convictions under Section 641, and the Second Circuit affirmed.
[18] *Id.* at *8. Much of the analysis in *Dirks* was focused on separating permissible and impermissible uses of confidential corporate information. *Dirks*, 463 U.S. at 661–62.
[19] 484 U.S. 19, 24 (1987).
[20] *Blaszczak*, 2019 WL 7289753, at *9.
[21] *Id.*
[22] *Id.* at *5.

contents of a Wall Street Journal column did constitute "property" for purposes of a Title 18 fraud prosecution.[23] The Court concluded that the information about CMS's planned changes in Medicare and Medicaid reimbursement rates is more like the prepublication contents of the newspaper column than the unissued government license because, among other things, CMS "invests time and resources into generating and maintaining the confidentiality of its non-public pre-decisional information," thereby acting as a "property holder, not as sovereign."[24]

Judge Kearse dissented, explaining that unlike the Wall Street Journal in *Carpenter*, CMS is "not a business" and its information is not "stock in trade;" it "does not seek buyers or subscribers; it is not in a competition; it is an agency of the government that regulates the conduct of others. It does so whether or not any information on which its regulation is premised is confidential."[25] According to the dissent, CMS' pre-decisional information is like the unissued licenses in *Cleveland*, "which the State had the right to control or withhold—but which had no property status or [economic impact] until they were issued."[26]

Takeaways

By relieving prosecutors of their burden to prove a tipper's "personal benefit" or a tippee's knowledge of that benefit, *Blaszczak* has made it easier to bring insider-trading cases, particularly against tippees who may be one or more levels removed from the initial tip.

It bears note that the SEC has no civil enforcement authority under the Title 18 fraud statutes, and must still bring its civil insider-trading cases under Section 10(b). Thus, after *Blaszczak*, it may be easier for the Justice Department to satisfy the elements of insider trading under Title 18 than for the SEC to satisfy the elements of insider trading under 10(b), although, of course, the Justice Department must prove its cases beyond a reasonable doubt, whereas the SEC has a lower burden of proof.

Despite its potentially significant implications, the decision's "personal-benefit" holding is not all that surprising. Long ago, the Supreme Court in *Carpenter* held that insider trading could be prosecuted under the mail and wire fraud statutes and there was no suggestion in that decision that "personal benefit" was a separate essential element of a wire or mail fraud conviction.[27]

Nor is it surprising that the *Blaszczak* Court reached the same result with respect to Section 1348. As the Court explained, the legislative history shows that Congress added Section 1348 to overcome the "technical legal requirements" of the Title 15 fraud provisions, and "provide prosecutors with a different—and broader—enforcement mechanism to address securities fraud."[28]

[23] *Id.* at *6.
[24] *Id.* at *7. The Court also rejected the argument that the government needed to show a "monetary loss" for its information to be considered property. *Id.*
[25] *Id.* at *18.
[26] *Id.* at *19.
[27] *See Carpenter*, 484 U.S. at 24 (splitting four to four on whether the misappropriation theory stated a cause of action under Section 10b but affirming convictions for mail and wire fraud); *see also United States v. Bryan*, 58 F.3d 933, 942–44 (4th Cir. 1995) (rejecting liability under Section 10b but affirming convictions for mail and wire fraud).
[28] *Blaszczak*, 2019 WL 7289753, at *9.

In addition, *Blaszczak*'s interpretation of the Title 18 fraud statutes is reminiscent of the reasoning of some earlier Section 10(b) misappropriation decisions: namely, that because the *Dirks* personal-benefit test was prompted by the need to distinguish permissible from impermissible uses of confidential corporate information, the test is unnecessary in a misappropriation case because the conduct at issue—stealing information—is inherently improper.[29]

But *Blaszczak*'s impact is broader than just misappropriation cases. Nothing in the decision suggests that its "personal benefit" holding cannot also be applied to the facts of a traditional insider-trading case—where corporate insiders disclose material nonpublic information about their companies.

Does this mean that Dirks himself—who avoided civil liability in his case against the SEC—could now be convicted criminally under the Title 18 fraud statutes? Not necessarily. Even in a "classical" insider-trading case like *Dirks*, prosecutors would still be required to prove under Title 18 that the defendant acted fraudulently, meaning that he embezzled, or misappropriated for his own use, the company's information. In *Dirks*, the insiders acted to expose corporate fraud, and "there was no expectation by Dirks' sources that he would keep their information in confidence. Nor did Dirks misappropriate or illegally obtain the information about [the company at issue]."[30] Thus, even without the protection of Section 10(b)'s personal-benefit test, a 2020 version of Dirks should be able to avoid conviction under the Title 18 fraud statutes.

Finally, while *Blaszczak*'s "personal-benefit" holding was foreshadowed by prior cases, its analysis of the "property" issue was novel, and could have gone the other way, as evidenced by Judge Kearse's dissent. It remains to be seen whether prosecutors will now become more aggressive in bringing insider-trading cases in the "political intelligence" area and, if so, whether the question of what constitutes "property" under the Title 18 fraud statutes will become the next nettlesome issue in the world of insider-trading jurisprudence.[31]

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CLEARY GOTTLIEB

[29] *Id.* (because embezzlement inherently involves a breach of duty, there is no requirement that the government prove a breach of duty in a specific manner, "let alone through evidence that an insider tipped confidential information in exchange for a personal benefit").

[30] *Dirks*, 463 U.S. at 665.

[31] This Alert Memorandum was prepared with the assistance of Shannon Daugherty and Benjamin Rosenblum.