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WHITE-COLLAR CRIME

Expert Analysis

Days Seem Numbered for Circuit's Controversial Insider Trading Decision

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A Second Circuit panel's decision last year in *United States v. Blaszczak*, 947 F.3d 19 (2d Cir. 2019) held that a government agency's confidential information can constitute "property" for purposes of federal criminal fraud statutes. That holding, which was the subject of a dissent by Judge Amalya Kearse, was undermined by the Supreme Court's subsequent unanimous decision reversing the convictions in the George Washington Bridge case, *Kelly v. United States*, 140 S.Ct. 1565 (2020), which held that "a scheme to alter … a regulatory choice is not one to appropriate the government's property." Days before Thanksgiving, the United States Solicitor General's office responded to defendants' petitions for certiorari in *Blaszczak*. The government agreed that the Supreme Court should vacate the panel's decision, and suggested a remand for further consideration in light of the intervening decision in *Kelly*.

But *Blaszczak* also included another holding that perhaps has attracted even more attention: that the "personal benefit" test announced by the Supreme Court for insider trading cases under Section 10(b) of the Securities Exchange Act does not apply to insider trading cases charged under the separate criminal fraud statutes in Title 18. That holding significantly widens the scope of criminal insider trading. It also creates the anomaly of extending the criminal law beyond the SEC's civil enforcement authority.

Even as the 'Blaszczak' litigation continues, the significant issues the certiorari petitions present in two critical areas of white-collar criminal doctrine are worthy of practitioners' attention.

If, as expected, the Supreme Court accepts the Solicitor General's suggestion, both of *Blaszczak*'s controversial holdings would no longer be binding, subject to subsequent proceedings in the Circuit. Even as the *Blaszczak* litigation continues, the significant issues the certiorari petitions present in two critical areas of white-collar criminal doctrine are worthy of practitioners' attention.

The Blaszczak Prosecution

David Blaszczak is a former employee of the Center for Medicare and Medicaid Services (CMS), a government agency that establishes the rates at which health care providers are reimbursed for services. Blaszczak often was retained as a consultant by various institutional investor clients, including Deerfield, a health care-focused investment fund where Robert Olan and Theodore Huber were analysts. Olan and Huber were responsible for making recommendations to others at the fund who made trading decisions. CMS relied on a regular flow of information back and forth with interested parties to inform its determinations. Evidence at trial showed that the fund's legal and compliance officers knew that Blaszczak continued to speak to his former CMS colleagues and approved of the fund's analysts using his information.

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On May 9, 2012, while CMS was considering its annual proposed reimbursement regulation for radiation-oncology treatment, Blaszczak conveyed to a Deerfield analyst, Jordan Fogel, his prediction that CMS would halve those reimbursement rates. Fogel conveyed this information to a large group at Deerfield, including Olan and Huber. The following day, Deerfield placed an order to short shares of a radiation-device manufacturer. Deerfield made approximately $2.7 million in profits on the trade. The government asserted that the information came to Blaszczak by way of his former CMS colleague and co-defendant, Christopher Worrall. The prosecution did not dispute that Olan, Huber and Fogel had no idea who Worrall was, let alone whether he provided information to Blaszczak and for what purpose.

The government filed charges against the defendants in the Southern District of New York for fraud in violation of Section 10(b) and Rule 10b-5 under Title 15 (15 U.S.C. §78j(b) & 78ff and 17 C.F.R. §240.10b-5); wire fraud (18 U.S.C. §1343); Title 18 securities fraud (18 U.S.C. §1348); conversion of government property (18 U.S.C. §641) and conspiracy (18 U.S.C. 371, 1349). In support of the Title 18 charges, the government asserted that the confidential government information—namely the predictions about what reimbursement rates CMS would propose for radiation-oncology treatment—constitutes government property. The government asserted that CMS invested time and resources into generating and maintaining the confidentiality of its proposed regulations and that disclosure would hamper the agency's decision-making process.

The government also argued that to establish insider trading under Title 18's fraud statutes, unlike under Title 15's Section 10(b), it need not prove that the tipper sought or obtained any personal benefit nor that the tippees knew that the information was disclosed for such a benefit. The government contended that it need only prove that Olan and Huber knew that the information came from an unauthorized disclosure from a government source.

The district court accepted these arguments and formulated its jury instructions accordingly. The jury acquitted all defendants of all Title 15 charges—apparently recognizing the absence of evidence of personal benefit—but convicted them of wire fraud, conversion, Title 18 securities fraud and conspiracy. The district court sentenced Blaszczak to 12 months and one day of imprisonment, Worrall to 20 months' imprisonment, and Huber and Olan each to 36 months' imprisonment and fines of $1,250,000.

On Dec. 30, 2019, a divided panel of the Second Circuit affirmed, with Judge Kearse dissenting. The panel majority endorsed the government's assertions—holding that the confidential information regarding CMS deliberations constituted government "property" under Sections 1343 and 1348 and that Title 18 securities fraud does not require proof of a tipper's personal benefit or a tippee's knowledge thereof to support an insider-trading conviction.

Defining 'Property' For Federal Criminal Fraud

In general, to violate Title 18's statutes barring fraud, a defendant must defraud someone of money or property. In *Cleveland v. United States*, 531 U.S. 12, 15 (2000), the Supreme Court held that lying to obtain a state license is not federal criminal fraud because licenses are not government "property." 531 U.S. at 15. Emphasizing that the fraud statutes do not extend beyond "traditional concepts of property," the court reasoned 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." Id. at 20-22, 24.

More recently, in *Kelly,* the court reiterated that where the government is the alleged fraud victim, the object of the scheme must interfere with the government's "role as … property holder," rather than where its core concern "is regulatory." In *Kelly*, two officials endeavored to punish the mayor of Fort Lee, NJ for refusing to support Gov. Chris Christie's re-election. As part of their effort, they limited the entrance lanes of the George Washington Bridge reserved for Fort Lee, entangling the town in traffic and claimed, falsely, that the redirection was for a traffic study. A jury convicted the officials for a number of offenses, including wire fraud. The court reversed, holding that the lane realignment was an "exercise of regulatory power" because the officials "regulated use of the lanes, as officials responsible for roadways so often do" or using "*Cleveland*'s words, [they] exercised the regulatory rights of 'allocation, exclusion, and control'—deciding that drivers from Fort Lee [would receive] fewer lanes." Any incidental expenditure of government labor did not convert a scheme focused on the government's role as regulator into a scheme to obtain property.

Background of Insider Trading Law's 'Personal Benefit' Rule

Congress never has passed a generally applicable criminal statute expressly barring insider trading; rather, the government prosecutes such conduct as a form of fraud, typically under the Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, which prohibit employing any "device, scheme, or artifice to defraud," or the use of "fraud or deceit," in connection with the purchase or sale of securities. In the seminal decision *Dirks v. SEC*, 463 U.S. 646 (1983), the Supreme Court explained that what makes insider trading deceptive, and thus fraudulent, is a breach of a duty of trust and confidence to the source of information through use of the information for "personal benefit." A recipient of insider information, a tippee, thus can be liable for securities fraud where he or she, knowing that the inside information was disclosed in violation of the insider's duty, then trades based on that information.

Dirks involved a financial analyst whose clients traded on confidential information he had received from a corporate whistleblower. The Supreme Court concluded that neither the whistleblower's disclosure nor the subsequent trades were fraudulent because the whistleblower acted to expose corporate wrongdoing, not for any personal benefit. "[T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty … . And absent a breach by the insider, there is no derivative breach" by a tippee trading on the disclosure. More recently, in *Salman v. United States*, 137 S. Ct. 420, (2016), the court reaffirmed *Dirks*: "[a] tipper breaches [his] fiduciary duty" only "when the tipper discloses the inside information for a personal benefit," and "the disclosure of confidential information without personal benefit is not enough" to establish fraud.

> Given the uncertain future of the 'Blaszczak' panel's personal benefit holding, district courts in the Second Circuit and elsewhere faced with Title 18 securities fraud charges in an insider trading prosecution may well find the most prudent approach to include the personal benefit requirement in their jury instructions.

The 'Blaszczak' Certiorari Petitions

On Sept. 9, 2020 Olan and Huber filed a petition for writ of certiorari. Blaszczak filed a substantially similar petition the next day. With respect to the Second Circuit panel's ruling that the unauthorized disclosure of government information constitutes "property," petitioners argue that it would extend the criminal law's coverage to routine activities or investment analysts and journalists, and directly conflicts with *Cleveland* and *Kelly*, both of which foreclose fraud prosecutions relating to government regulatory information. The government has no "traditional" economic interest in predictive information about what regulation the government may propose, which the government does not sell, and because the government can—and did—issue the same regulation it planned regardless of the disclosure, the disclosure does not deprive the government of anything of value to it. The panel majority's reliance on *Carpenter v. United States*, 484 U.S. 19 (1987), is misplaced because, as Judge Kearse explained in her dissent, *Carpenter* addressed a business's self-evident economic interest in selling information, which a government regulator lacks.

Turning to the second question presented by the petition, the petitioners assert that the panel's ruling would work a "sea change" in law by effectively criminalizing all trading on material nonpublic information, no matter how obtained, thereby upsetting the careful balance struck by the court in *Dirks* to ensure the information flow required for efficient securities markets. The ruling also conflicts with the court's most recent *Dirks*-related ruling, *Salman*, in which the court unanimously rejected the government's invitation to replace the personal-benefit test with a standard that would find conduct fraudulent "whenever the tipper discloses confidential trading information for a noncorporate purpose."

The petitioners also argue that the panel's assertion that the personal benefit requirement established by *Dirks* is "premised" on Congress having "enacted Title 15 fraud provisions with the limited 'purpose of … eliminat[ing] [the] use of inside information for personal advantage" is incorrect.

The petitioners point out that "[n]othing in *Dirks* limits its holding to Title 15 or otherwise suggests that the court intended to implement some statutory purpose unique to Section 10(b)" and to the *Dirks*' opinion's characterization—repeated no less than seven times—of a personal benefit as essential and indispensable to the existence of a fraud, because absent such a benefit there has been no deceit. They also argue that the circuit panel's assertion that "*Carpenter*'s formulation of embezzlement" fraud does not require personal benefit is similarly incorrect, pointing to language in *Carpenter* that a person who obtains information by way of a fiduciary relationship "is not free to exploit that knowledge or information for his own personal benefit … ." Petitioners also reject the panel's suggestion that Section 1348 should receive treatment different from that of other fraud statutes with substantially identical operative language based on impermissible "atextual speculation about statutory purpose," that would create an "irrational disparity between criminal and civil insider-trading actions," and an unpredictable rule subjecting market actors to prosecution for simply doing their jobs to ferret out information.

Amicus Briefs

An investment management industry group, the Alternative Investment Management Association (AIMA), submitted an amicus brief arguing that expanding the definition of property to include government information threatens to chill the appropriate information discovery process necessary to healthy, efficient market. AIMA also pointed out that abandoning the personal benefit test does not reflect the will of Congress, because in 2012 Congress passed a statute, the "Stop Trading on Congressional Knowledge Act," that expressly applied the standards of Section 10(b) to government employees.

The National Association of Criminal Defense Lawyers (NACDL) submitted an amicus brief stressing the argument that the Second Circuit's interpretation of "property" criminalizes the free flow of information about the government's plans, a core First Amendment activity. A group of securities law professors also submitted an amicus brief stressing that the Second Circuit dispensed with the personal benefit rule on the erroneous view that it was based on policy reasons rather than deeply rooted in the definition of fraud.

Government Response To the Petitions

On Nov. 24, 2020, the Solicitor General's Office filed a three-page response to the petitions, asking the Supreme Court to grant the petitions for writs of certiorari, vacate the decision below, and remand the case for further consideration in light of intervening decision in *Kelly*. The government asserts that a remand is appropriate to allow the Second Circuit to consider the impact of *Kelly* and issue a written decision addressing it.

Conclusion

By reply filed Dec. 8, 2020, the petitioners argued that the government's failure to defend the panel's decision was a striking reversal of its position below and asked the court to either summarily reverse the panel's decision or accept the case for full hearing. If, as likely, the Supreme Court at least accepts the Solicitor General's suggestion to vacate the decision below, the panel's decision—that is, both its "property" and "personal benefit" holdings—would no longer be binding precedent in the Second Circuit. Although the Solicitor General expressly proposes a remand regarding only the first issue presented by the certiorari petitions, the petitions raise such serious questions regarding the *Blaszczak* panel's personal benefit holding that that holding seems destined for further review, whether in *Blaszczak* or otherwise. Notably, any further review at the Circuit would not be undertaken by the identical *Blaszczak* panel because one member, Judge Christopher Droney, retired from the bench just days after issuance of the original opinion. In the interim, given the uncertain future of the *Blaszczak* panel's personal benefit holding, district courts in the Second Circuit and elsewhere faced with Title 18 securities fraud charges in an insider trading prosecution may well find the most prudent approach to include the personal benefit requirement in their jury instructions.