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The Muddy Waters of Insider Trading Law Just Got Muddier

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In December 2022 in *United States v. Blaszczak*, 56 F.4th 230 (2d Cir. 2022) (*Blaszczak II*) a Second Circuit panel issued a ruling vacating the court's controversial three-year-old decision in *United States v. Blaszczak*, 947 F.3d 19 (2d Cir. 2019) (*Blaszczak I*). In *Blaszczak I* the Second Circuit held that a government agency's confidential information can constitute "property" for purposes of federal criminal fraud statutes and 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 securities fraud provision in Title 18 (18 U.S.C. §1348). Illustrating the ever-shifting sands at the foundation of insider trading law, while defendants' certiorari petitions were pending in *Blaszczak I*, the Supreme Court issued *Kelly v. United States*, 140 S. Ct. 1565 (2020), and as predicted, the Supreme Court vacated the decision in *Blaszczak I* and remanded the case to a different panel of Second Circuit Judges—Judge John Walker replaced Judge Christopher Droney who retired days after issuance of the original opinion—for further consideration. See Robert J. Anello and Richard F. Albert, *Days Seem Numbered for Circuit's Controversial Insider Trading Decision*, NYLJ (Dec. 10, 2020).

On remand, in a familiar turn of events, Judge Amalya Kearse, writing for the majority, vacated defendants' convictions on the very ground of her dissent in *Blaszczak I*, leaving intact *Blaszczak I*'s conclusion that Section 1348 does not require proof of personal benefit. A forceful concurrence by Judge Walker, joined by Judge Kearse, calls into question this second holding and cautions of the dire consequences for legitimate market activity. In recognition of the persistent doctrinal flux, Judge Walker calls on Congress and the courts to require the government to demonstrate proof of a personal benefit to secure a Section 1348 conviction. Given the procedural posture of the *Blaszczak* case and the lack of judicial precedent in other circuits, Judge Walker's insights add more mud to the already muddy waters of insider trading law in the Second Circuit and elsewhere.

The Friends With Benefits Requirement of Insider Trading Liability

The sense of whiplash that some may feel after the *Blaszczak* opinions is not a new phenomenon in insider trading law. Instead, the decision builds on the already unsteady foundation of a confusing array of cases. In the seminal decision *Dirks v. SEC*, 463 U.S. 646 (1983), the Supreme Court, drawing on the purpose of the Exchange Act, held that liability for insider trading requires proof that an individual—the "tipper"—disclosed material, nonpublic information in exchange for a "personal benefit." "[T]he test is whether the insider personally will benefit, directly or indirectly from his disclosure." The 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 a "personal benefit." A recipient of insider information—a "tippee"—also 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. Since *Dirks*, the Second Circuit has

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attempted to clarify the scope of this test, in a back-and-forth dialogue with the Supreme Court that has led it to revise and circumscribe prior opinions. See, e.g., *United States v. Newman*, 773 F.3d 438, 447-49 (2d Cir. 2014), abrogated by *Salman v. United States*, 137 S. Ct. 420 (2016); *United States v. Martoma*, 869 F.3d 58 (2d Cir. 2017) *rev'd*, 894 F.3d 64 (2d Cir. 2018).

In contrast to the frequently litigated requirements of the test under the Exchange Act, Section 10(b) and Rule 10b-5 (15 U.S.C. §78j(b) & 78ff and 17 C.F.R. §240.10b-5) (collectively, Section 10b), the *Blaszczak I* panel was the first appeals court to address whether *Dirks* applies to Section 1348. Since *Blaszczak I*, two appellate courts have relied on *Blaszczak I* for the proposition that Section 1348 is intended to give prosecutors broader enforcement power to address insider trading, with the 5th Circuit specifically joining *Blaszczak I* in holding that a Section 1348 conviction does not require proof of a personal benefit. See *United States v. Jonas*, 824 F. App'x 224 (5th Cir. 2020); see also *United States v. Hussain*, 972 F.3d 1138 (9th Cir. 2020).

'Blaszczak' Majorities

The prosecution of David Blaszczak, a political intelligence consultant, involved allegations that he received confidential information concerning prospective changes to Medicare reimbursement rates from his former colleagues at the Centers for Medicare & Medicaid Services (CMS) and passed this information on to investment fund analysts, who in turn relayed the information to individuals who executed profitable trades in companies affected by the changed rates. The government charged Blaszczak, along with his co-defendants—the fund's analysts and the CMS employee who supplied the information—in the Southern District of New York for engaging in insider trading in violation of Section 10(b) and Rule 10b-5, and for wire fraud, securities fraud, conversion of government property, and conspiracy to commit the same, in violation of 18 U.S.C. §§1343, 1348, 641, 371, and 1349 (collectively, Title 18 charges).

To support the Title 18 charges, the government relied on the fact that CMS's confidential information—namely the predictions about what reimbursement rates CMS would propose and when—constituted government "property." The government also argued, and the district court agreed, that to establish insider trading under Section 1348, the government need not prove that the tipper at CMS sought or obtained a "personal benefit." Instead, the court's instructions permitted the jury to find defendants liable under Section 1348 upon a finding that the analysts knew the information came from an unauthorized disclosure from a government source, but they did not need to know the source or for what purpose the source provided the information. The jury ended up acquitting all defendants of Section 10b securities fraud—apparently recognizing the absence of evidence of a personal benefit—but found the defendants guilty of the Title 18 charges.

The defendants appealed their convictions and in December 2019, a divided panel of the Second Circuit affirmed, finding that CMS's confidential information qualifies as property and that the personal benefit test announced in *Dirks* does not apply to insider trading cases charged under Section 1348. The majority reasoned that although the two statutes share similar text and proscribe similar theories of fraud, the Supreme Court created the personal benefit test entirely to effectuate the purpose of Exchange Act, namely "'eliminat[ing] [the] use of inside information for *personal advantage*.'" *Blaszczak I*, 947 F.3d at 35 (quoting *Dirks*, 463 U.S. at 662). Because the meaning of "defraud" in Section 1348 was intended to be broader than in Section 10b and include the "embezzlement" theory of fraud recognized in *Carpenter v. United States*, 484 U.S. 171 (1987), the majority reasoned that *Dirks* should be limited to Section 10b cases. Judge Kearse issued a dissenting opinion, arguing that CMS's predecisional regulatory information should not be considered government property.

While defendants' certiorari petitions were pending, the Supreme Court issued *Kelly*—the Bridgegate case—which held that the object of an alleged fraud—the Port Authority's right to control traffic lane alignment on the George Washington Bridge—did not constitute "property" belonging to the government. See Robert J. Anello and Richard F. Albert, *Bridgegate: Open Questions After Supreme Court Narrows Fraud Statutes*, NYLJ (June 10, 2020). The *Blaszczak* defendants argued, and the Solicitor General's office agreed, that *Kelly* mandated reversal of their convictions as well because, like the right to control traffic lanes, information concerning the timing of CMS's reimbursement rates does not constitute a property interest. The Supreme Court vacated *Blaszczak I* and sent the case back to the Second Circuit for further consideration.

In another split decision, the majority—this time speaking through Judge Kearse in an opinion reminiscent of her *Blaszczak I* dissent—granted the government's request to vacate defendants' convictions on grounds of prosecutorial discretion and the majority's independent finding that after *Kelly*, revealing CMS's confidential discussions concerning reimbursement rate changes and the timing

of their disclosure could no longer qualify as an appropriation of the government's "property," but rather constitutes "a scheme to alter … a regulatory choice." Because defendants' convictions were overturned on the "property" issue, the majority did not reach or even mention its prior controversial holding that no showing of a "personal benefit" is necessary under Section 1348.

'Blaszczak II' Concurrence

Blaszczak I technically remains the law on the personal benefit issue—*Blaszczak II* vacated the defendants' convictions on other grounds and an opinion that is later vacated on other grounds remains binding on the issues not touched by the vacatur– but as a practical matter, Judge Walker's "concurrence" joined by Judge Kearse weakens the panel's prior holding. Judge Walker wrote separately to "highlight a glaring anomaly" created by *Blaszczak I* and the resulting "risk of overdeterrence [that] looms large." Judge Walker points out that without the requirement of personal benefit, Section 1348 criminalizes more instances of insider trading than are civilly sanctionable under Section 10b. Although the higher standard of proof in criminal cases may "mitigate this incongruence to a degree," the threat of criminal penalties is a "weighty cudgel in plea agreements and in extracting civil settlements. It also poses a challenge to the lawyer advising the security analyst who has no desire to run afoul of the law but wants to be able to do his job effectively." The incongruence is particularly concerning, Judge Walker cautions, because of the chilling effect it is likely to have on legitimate market activity. Quoting from the government's brief in *Dirks*, Judge Walker writes, "the government has expressly acknowledged that securities analysts, who routinely 'ferret out and analyze information' from corporate insiders to price accurately a security, are critical to a functioning market" and may "appropriate engage[] in the honest disclosure and collection of corporate information." Without a line in the sand to delineate the bounds of permissible conduct under Section 1348, corporate insiders will be more reticent to share lawful information with analysts and analysts will be less likely to act on such information. That line in the sand, or safeguard against criminalizing honest disclosure and collection of corporate information, is the personal benefit test. Recognizing the substantial uncertainty in the doctrine and predicting difficulties in future cases, Judge Walker calls on Congress to preemptively address the perverse result.

Judge Sullivan in dissent argues that the difference in requirements for liability under the two federal antifraud statutes "is not surprising, and certainly not unique in American law," and although "as a matter of policy or equity" the standards should be the same, "there is nothing in the statutes or case law that compels such a conclusion." In fact, based upon the legislative history and purpose of Section 1348, in Judge Sullivan's view, Congress did not intend Section 1348 to be "a mere carbon copy" of Section 10b. Apparently the "personal benefit" test is one of the distinguishing factors. Judge Sullivan cautions that it is not the court's position to second-guess Congress, regardless of any "troubling effects."

Conclusion

The procedural posture of *Blaszczak* adds new cracks to the already unstable foundation of insider trading precedent. Although *Blaszczak II* vacated defendants' convictions, the majority did so on grounds other than the personal benefit issue, meaning that *Blaszczak I*'s conclusion that *Dirks* does not apply to Section 1348 technically remains intact. Judge Walker (and Judge Kearse) acknowledge as much, but their warnings and call for reform weaken the force of *Blaszczak I*'s conclusion as a practical matter. Other courts are left with confusing guidance on how to proceed.

One may predict with confidence, however, that despite the persistent uncertainty concerning the "personal benefit" test, prosecutors are likely to bring more Section 1348 charges as a shortcut to obtaining insider trading convictions. Investment advisors and research firms are likely to heed the cautionary tale of *Blaszczak I* and revise their compliance procedures accordingly. Because this reaction may have a chilling effect on permissible and necessary market activity, and history shows that any case law that develops is likely to be unstable, legislative intervention would be welcomed to uncloud the water in at least one area of insider trading law and determine the applicability of the "personal benefit" test to Section 1348 prosecutions. Legislative intervention would be particularly welcomed given the lack of further review available in *Blaszczak*—the government's concession of error makes it highly unlikely that either party will seek rehearing in the Second Circuit or certiorari in the Supreme Court, leaving courts and practitioners to grapple with uncertainties of *Blaszczak I and II*.