SULLIVAN & CROMWELL LLP

January 6, 2020

U.S. v. *Blaszczak* – "Personal Benefit" Test Does Not Apply to Title 18 Insider Trading Cases

The Second Circuit Lowers the Standard for Proving Title 18 Insider Trading, Making It Easier for the Government to Bring Insider Trading Cases Where There Is No "Personal Benefit" to the Insider Who Discloses Information

SUMMARY

On December 30, 2019 the Second Circuit upheld the convictions of David Blaszczak and three others for their roles in a scheme to trade on information about upcoming regulatory changes by the Centers for Medicare & Medicaid Services (CMS).[1] In so doing, the Court ruled that, in a prosecution brought pursuant to 18 U.S.C. § 1343 and § 1348, which criminalize wire and securities fraud, respectively, the government need not prove that the defendants received a "personal benefit" in exchange for the provision of material nonpublic information as is required under 15 U.S.C. § 78j(b), which prohibits insider trading.[2] The Court's holding could prompt the government to make greater use of § 1343 and § 1348 in prosecuting insider trading cases.

The majority of the Court also held that pre-decisional regulatory information regarding upcoming rule changes could constitute "property" for purposes of 18 U.S.C. § 1343 and § 1348. One judge dissented, however, arguing that the government's interest in rule-making information is purely regulatory.

BACKGROUND

The Securities and Exchange Act of 1934 provides for criminal prosecution of individuals who engage in insider trading, codified at Title 15 of the U.S. Code (Exchange Act or Title 15).[3] In 1983, the Supreme Court in *Dirks* v. *S.E.C.* held that in order to be liable for insider trading under Title 15, the insider must receive a direct or indirect "personal benefit" from the disclosure.[4] In 2002, Congress passed the Sarbanes-Oxley Act, which added to the federal criminal code a new provision for criminal insider trading, codified at 18 U.S.C. § 1348[5] (Sarbanes-Oxley Act, together with the wire fraud provision of 18 U.S.C. § 1343, the Title 18 Fraud Statutes).[6] Note also that this provision was amended in 2009 to expand the scope of the criminal insider trading prohibition beyond securities and to commodity futures and options transactions.

After *Dirks*, the Second Circuit grappled with how to define "personal benefit." In *United States* v. *Newman*, the Second Circuit held that to show "personal benefit," the government must demonstrate that the insider received something "pecuniary or similarly valuable in nature."[7] This holding was subsequently abrogated by the Supreme Court in *Salman* v. *United States*, which held that the required "personal benefit" could be a "reputational benefit."[8] Thereafter, in *United States* v. *Martoma*, the Second Circuit held that evidence that the insider's disclosure of information was intended to benefit the tippee could demonstrate "personal benefit."[9] Finally, in January 2019, in *Gupta* v. *United States*, the Second Circuit upheld an insider trading conviction expressly acknowledging that the Supreme Court had rejected *Newman*'s definition of the "personal benefit" requirement, and recognizing that the "personal benefit" may be "indirect and intangible."[10]

Set against this evolving legal landscape, at issue in *Blaszczak* was whether the "personal benefit" test announced in *Dirks* and clarified by *Salman*, *Martoma*, and *Gupta*, applied not just to Title 15 insider trading, but also to prosecutions brought pursuant to the Title 18 Fraud Statutes.

In *Blaszczak*, Defendant Blaszczak, along with three co-conspirators, were charged under both Title 15 and the Title 18 Fraud Statutes in connection with the sharing of and subsequent trading based on pre-decisional regulatory information.[11] Generally, when Blaszczak received insider information on an upcoming rule change by CMS, he would share it with contacts at a hedge fund, who would then short the stock of a company that would be negatively impacted by the rule change.[12]

At trial, consistent with the Supreme Court's holding in *Dirks* and its progeny, the district court instructed the jury that in order to find a defendant guilty of Title 15 securities fraud, the jury must find that the defendant received some "personal benefit."[13] The district court, however, declined to give the same "personal benefit" instruction for the Title 18 Fraud Statutes.[14]

Blaszczak and two of his co-defendants were acquitted of all counts charging Title 15 securities fraud but were convicted under the Title 18 Fraud Statutes. Defendants appealed, arguing that the district court erred by not instructing the jury that the *Dirks* personal-benefit test also applied to the Title 18 Fraud Statutes.[15] Essentially, Defendants argued that the elements of the Title 18 Fraud Statutes and Title 15 "should be construed so that the elements of insider-trading fraud are the same."[16]

On appeal, Defendants also argued that their convictions must be reversed because there was insufficient evidence to prove that they engaged in a scheme to defraud CMS of "property," as required by the Title 18 Fraud Statutes, because CMS's confidential information did not constitute "property."[17]

THE SECOND CIRCUIT'S DECISION

The Second Circuit held that in order to prove insider trading under the Title 18 Fraud Statutes, the government is not required to prove a defendant derived a "personal benefit" from the disclosure. The three-judge panel was comprised of Judges Richard J. Sullivan (who authored the opinion), Amalya L. Kearse, and Christopher F. Droney.

The Court first explained that neither the Title 18 Fraud Statutes nor Title 15 include the words "personal benefit" and that both the Title 18 Fraud Statutes and Title 15 encompass "the so-called 'embezzlement' or 'misappropriation' theory of fraud," which is "the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another."[18] The Court explained that while the Title 18 Fraud Statutes and Title 15 have "similar text and proscribe similar theories of fraud" "these common features have little to do with the personal-benefit test."[19]

The personal-benefit test, according to the Court, was developed as a judge-made doctrine premised on the Exchange Act's statutory purpose—*i.e.*, eliminating the use of "inside information for *personal advantage*."[20] The Sarbanes-Oxley Act's amendments to the criminal code, however, were intended in large part to overcome the "technical legal requirements" of the Exchange Act fraud provisions.[21]

The Court reasoned that once "untethered from the statutory context in which it arose, the personal-benefit test finds no support in the embezzlement theory of fraud."[22] The Court explained that "[i]n the context of embezzlement, there is no additional requirement that an insider breach a duty to the owner of the property, since it is impossible for a person to embezzle the money of another without committing a fraud upon him."[23] Moreover, there is "no additional 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."[24] Thus because, the personal-benefit test depends "entirely on the purpose of the Exchange Act," the Court declined to extend its application beyond the context of that statute.[25]

Defendants also argued that the government may prosecute insider trading cases under the Title 18 Fraud Statutes with less difficulty by avoiding the personal-benefit test altogether.[26] The Court acknowledged this possibility but concluded that, regardless of policy implications, it is Congress's right to enact broader criminal statutes penalizing insider trading.[27]

With respect to Defendants' argument that pre-decisional regulatory advice cannot constitute "property" under the Title 18 Fraud Statutes, the majority held that it could, while Judge Kearse dissented. The majority likened pre-decisional information to that of a unpublished newspaper article, which the Supreme Court has held constituted "property" for purposes of a wire fraud prosecution, because the newspaper had a "right to exclude" others from knowing the information.[28] The majority reasoned that CMS, similarly, had a right to exclude others from its nonpublic pre-decisional information.[29] Judge Kearse disagreed, concluding that "unlike the information that was planned for publication by the news publisher," "information is not CMS's 'stock in trade,'" as "CMS does not seek buyers or subscribers" and "it is not in a competition."[30] Rather, Judge Kearse wrote, "it is an agency of the government that regulates the conduct of others" and "pre-decisional CMS information has no economic impact on the government until" CMS has actually decided what regulations to issue.[31]

IMPLICATIONS

Following the Second Circuit's decision in *Blaszczak*, one can expect to see charges brought under both Title 15 and the Title 18 Fraud Statutes in criminal insider trading cases, particularly where the government cannot prove (or faces challenges in proving) that the insider received a personal benefit in exchange for providing material non-public information. The crux of criminal insider trading trials may instead focus on whether the defendant breached a duty to keep material non-public information a secret.

While other federal circuit courts of appeal have not addressed this issue, in light of *Blaszczak*, it can be expected that they will do so in the near future.

Blaszczak may also result in a future divergence between criminal insider trading prosecutions brought by the DOJ and civil prosecutions brought by the SEC. Until now, the DOJ and SEC typically acted in parallel in charging insider trading cases based on similar factual and legal theories. Because the SEC's enforcement jurisdiction is limited to Title 15, however, it must still prove a personal benefit consistent with *Dirks* (as clarified by *Salman*, *Martoma*, and *Gupta*). Accordingly, particularly in cases where a personal benefit on the part of the tipper is difficult to show, the DOJ may choose to bring prosecutions where the SEC declines, or may proceed under a different legal theory.

In addition, Judge Kearse's dissent shows that there may be additional room for argument as to what type of information may constitute "property" under the Title 18 Fraud Statutes and whether an agency has a "right to exclude" others from knowing that information. Moreover, the government may argue in future prosecutions that proving the traded information is "property" is not a necessary element in insider trading prosecutions brought under 18 U.S.C. § 1348(1). The majority noted that § 1348(1) does not include the term "property," but rather a "scheme or artifice . . . to defraud" in connection with securities. However, since the government did not argue that the "scheme or artifice" was anything other than "property" the court did not have reason to analyze whether "property" is a necessary element of § 1348(1).[32]

Finally, it is worth noting that the "Insider Trading Prohibition Act" (HR 2534) that passed the House of Representatives last month by a vote of 410-13 and is currently being considered by the U.S. Senate would have no obvious impact on the holding of *Blaszczak*. That bill, which was sponsored by Representative Jim Himes, attempts to define the circumstances in which trading based on material nonpublic information is unlawful, and would not require that the government prove that the trader-tippee was aware of a personal benefit to the tipper. But the Himes bill if passed would amend only Title 15 and would not alter the elements the DOJ must prove to bring a criminal insider trading prosecution under the Title 18 Fraud Statutes.

* * *

ENDNOTES

1 *United States* v. *Blaszczak, et al.*, No. 18-2825, U.S. Court of Appeals for the Second Circuit (*Blaszczak*).

2 *See Dirks* v. *S.E.C.*, 463 U.S. 646 (1983).

3 15 U.S.C. § 78j(b).

4 *Dirks*, 463 U.S. at 663.

5 18 U.S.C. § 1348.

6 Defendants in this case were also charged with wire fraud, 18 U.S.C. § 1343, premised on the same set of facts as the securities fraud charges. Defendants argued that the personal benefit test should also apply to this statute, which criminalizes "obtaining money or property by means of" false pretenses. *Blaszczak* at 26; 18 U.S.C. § 1343. The court, and this memorandum, refer to both as the "Title 18 Fraud Statutes."

7 *United States* v. *Newman*, 773 F.3d 438, 452 (2d Cir. 2014), *abrogated by Salman* v. *United States*, 137 S. Ct. 420 (2016).

8 *Salman*, 137 S. Ct. at 427.

9 *United States* v. *Martoma*, 894 F.3d 64, 76-80 (2d Cir. 2017).

10 *Gupta* v. *United States*, 913 F.3d 81, 87 (2d Cir. 2019).

11 *Blaszczak* at 5-6.

12 *Id.* at 5-9.

13 *Id.* at 12-13.

14 *Id.* at 13.

15 *Id.* at 26-27.

16 *Id.* at 27.

17 *Id.* at 16-17.

18 *Id.* at 27-28 (internal quotations omitted).

19 *Id.* at 28.

20 *Id.* at 28 (emphasis in original).

21 *Id.* at 31 (internal quotations omitted).

22 *Id.* at 29.

23 *Id.* at 29-30 (internal quotations omitted).

24 *Id.* at 30.

25 *Id.* at 30.

26 *Id.* at 32.

27 *Id.* at 32. The Court also held that pre-decisional regulatory information constituted "property" for the purposes of wire fraud and Title 18 securities fraud, there was sufficient evidence to support the jury's verdict on each count of the conviction, and the district court did not commit reversible error with respect to any evidentiary ruling. *Id.* at 26, 49, 54. The Court also rejected Defendant Blaszczak's argument that it was reversible error to join counts related to a separate insider trading scheme with the scheme involving all defendants, but the Court determined there was substantial overlap between the two schemes to warrant joinder. *Id.* at 51.

ENDNOTES (CONTINUED)

[28] *Id.* at 19-20 (citing *Carpenter* v. *United States*, 484 U.S. 19, 27 (1987)).

[29] *Id.* at 22. The court also noted that despite Defendants' arguments otherwise "government agencies have strong interests – both regulatory and economic – in controlling whether, when, and how to disclose confidential information relating to their contemplated rules." *Id.* at 25-26.

[30] *Blaszczak* Dissent at 4.

[31] *Blaszczak* Dissent at 7.

[32] *Blaszczak* at 16-17 n.1.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.

CONTACTS

New York		
Nicolas Bourtin	+1-212-558-3920	bourtinn@sullcrom.com
David H. Braff	+1-212-558-4705	braffd@sullcrom.com
Robert E. Buckholz	+1-212-558-3876	buckholzr@sullcrom.com
Justin J. DeCamp	+1-212-558-1688	decampj@sullcrom.com
Theodore Edelman	+1-212-558-3436	edelmant@sullcrom.com
Stephen Ehrenberg	+1-212-558-3269	ehrenbergs@sullcrom.com
Nicole Friedlander	+1-212-558-4332	friedlandern@sullcrom.com
Robert J. Giuffra Jr.	+1-212-558-3121	giuffrar@sullcrom.com
Richard H. Klapper	+1-212-558-3555	klapperr@sullcrom.com
Sharon Cohen Levin	+1-212-558-4334	levinsc@sullcrom.com
Ryne V. Miller	+1-212-558-3268	millerry@sullcrom.com
Sharon L. Nelles	+1-212-558-4976	nelless@sullcrom.com
Ann-Elizabeth Ostrager	+1-212-558-7357	ostragerae@sullcrom.com
Samuel W. Seymour	+1-212-558-3156	seymours@sullcrom.com
Kamil R. Shields	+1-212-558-7996	shieldska@sullcrom.com
Stephanie G. Wheeler	+1-212-558-7384	wheelers@sullcrom.com
Alexander J. Willscher	+1-212-558-4104	willschera@sullcrom.com
Washington, D.C.		
Aisling O'Shea	+1-202-956-7595	osheaa@sullcrom.com
Christopher Michael Viapiano	+1-202-956-6985	viapianoc@sullcrom.com
Judson O. Littleton	+1-202-956-7085	littletonj@sullcrom.com

Los Angeles

Anthony J. Lewis	+1-310-712-6615	lewisan@sullcrom.com
Adam S. Paris	+1-310-712-6663	parisa@sullcrom.com
Robert A. Sacks	+1-310-712-6640	sacksr@sullcrom.com

Palo Alto

Brendan P. Cullen	+1-650-461-5650	cullenb@sullcrom.com
Laura Kabler Oswell	+1-650-461-5679	oswelll@sullcrom.com

London

Theodore Edelman	+44 (0)20 7959 8450	edelmant@sullcrom.com