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Second Circuit Allows Insider Trading to Be Proven Without Personal Benefit

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A recent decision issued by the Second Circuit Court of Appeals could have important implications on the scope of insider trading liability and may make it easier for criminal prosecutors to bring such cases. The prohibition on insider trading under federal law has been developed, not by statute, but by judicial decisions interpreting the application of general anti-fraud statutes to forms of insider trading. In interpreting Section 10(b) of the Securities Exchange Act (Title 15 securities fraud), courts have required the government to prove that the tipper received some form of personal benefit and that the trader (who is sometimes a step or two removed from the insider) was aware of the personal benefit. These requirements have been difficult for the government to meet and have served as a limitation on the government's ability to subject defendants to criminal and civil liability for insider trading.

In *US v. Blaszczak*[1], the court faced the question of whether these limitations applied when prosecutors charged the wire fraud and other statutes to prove insider trading. The court sided with the government and affirmed the convictions of two former analysts at a major hedge fund, a political intelligence consultant, and a former government employee for wire fraud and conversion of US property and also affirmed the jury's verdict that the defendants (except the former government employee) were guilty of Title 18 securities fraud and conspiracy. In doing so, the court found that (a) confidential government information can constitute property under the wire fraud and Title 18 securities fraud statutes, and (b) the personal benefit test traditionally required in Section 10(b) cases does *not* apply to cases premised on wire fraud and Title 18 securities fraud.

This opinion thus permits prosecutors to prove insider trading without proving the tipper received a personal benefit in exchange for the inside information, or by extension that a remote tippee was aware that the tipper received a personal benefit in exchange for the inside information. This could have the effect of subjecting defendants to possible criminal liability even in situations in which the government is unable to meet the elements of Section 10(b) and the SEC is unable to bring a civil case. As detailed below, this decision has major implications for those responsible for complying with insider trading law and may set up a Supreme Court test for the government's aggressive use of non-Title 15 charges.

Background

The government's case in *US v. Blaszczak* was premised on the theory that employees of the Center for Medicare and Medicaid Services (CMS) improperly disclosed information to a political intelligence consultant who tipped the information to employees of a hedge fund who used it to make timely and profitable trades. To prove insider trading under Section 10(b) of Title 15, the Supreme Court and the Second Circuit have recognized the government must prove that the insider received a benefit and that the trader was aware of the benefit. In *Blaszczak,* the government did not allege that any cash or directly pecuniary benefit was paid in connection with the tips. Like *US v. Newman*,[2] then, the case involved hedge fund employees at least one step away from the alleged insider who used that information to make profitable trades on behalf of the hedge fund. It is precisely the sort of case in which the government would be expected to have possible problems proving benefit and knowledge of the benefit.

Although *Newman* (and *Dirks v. SEC*[3]) involved Section 10(b) charges, prosecutors can also charge wire fraud (outlawing obtaining property fraud via use of wires) or Title 18 securities fraud (outlawing, among other things, obtaining money or property via a fraud involving a securities fraud). In charging Blaszczak, the United States Attorney's Office included wire fraud and Title 18 securities fraud charges and asserted that they could meet the elements of these fraud statutes without proving a personal benefit. After trial, the jury acquitted Defendants of Section 10(b) charges, but found Defendants guilty of wire fraud and conversion and found the hedge fund employees and the political intelligence consultant (but not the CMS employee) guilty of Title 18 securities fraud and conspiracy. Defendants' appeal thus squarely put at issue the reach of wire fraud and Title 18 securities fraud when used to address insider trading.

The Second Circuit's Holding

As a first step of determining whether the wire fraud and Title 18 securities fraud statutes applied, the court first considered whether the CMS's confidential information was "property." For these purposes, property is defined as "something of value" in the possession of the property holder (in this context, the fraud victim).[4] In concluding that the CMS's nonpublic predecisional information was property, the court relied heavily on the Supreme Court's holding in *Carpenter* that information in forthcoming news articles could be "property" because the newspaper "had a property right in keeping confidential and making exclusive use" of the information before publication.[5] The court found that the CMS nonpublic predecisional information similarly constituted property because CMS had a "right to exclude" comparable to the newspaper in *Carpenter*. Although the court did not require a showing that the government's information be economic in nature, it emphasized that "the evidence at trial established that CMS invests time and resources into generating and maintaining the confidentiality of its nonpublic predecisional information—resources that are devalued when the information is leaked to members of the public."[6]

The Second Circuit then turned to the question of whether the government could prove wire fraud and Title 18 securities fraud without showing a personal benefit. Defendants argued that the Supreme Court's holding in *Dirks* (which arose under Section 10(b) of Title 15) should be read to require the showing of a personal benefit to prove that the taking of information was tantamount to fraud. That is, as the court acknowledged, "Defendants argue[d] that the term 'defraud' should be construed to have the same meaning across the Title 18 fraud provisions and Rule 10b-5, so that the elements of insider-trading fraud are the same under each of these provisions."[7]

In rejecting this argument, the court emphasized that the personal-benefit test is not explicitly required by any of the relevant statutes. "While the Title 18 fraud statutes and Title 15 fraud provisions thus share similar text and proscribe similar theories of fraud, these common features have little to do with the personal-benefit test."[8] The court emphasized that "the personal-benefit test is a judge-made doctrine premised on the Exchange Act's statutory purpose" of protecting the free flow of information "with the limited 'purpose of… eliminat[ing] [the] use of inside information for *personal advantage*."[9] The court emphasized that "once untethered from the statutory context in which it arose, the personal-benefit test finds no support in the embezzlement theory of fraud recognized in *Carpenter.*"[10] As in its finding concerning the definition, the court cited *United States v. Carpenter* (in which the Supreme Court affirmed a wire fraud conviction and was equally divided on a Title 15 securities fraud conviction) as a key precedent justifying its approach.

The court was thus comfortable with a result in which fraud could have different meaning for different statutes. In finding that the government did not have to prove a personal benefit, the court acknowledged (as Defendants contended) that the "government may avoid the personal-benefit test altogether by prosecuting insider-trading fraud with less difficulty under the Title 18 fraud statutes."[11] The court emphasized that "whatever the force of this argument as a policy matter, we may not rest our interpretation of the Title 18 fraud provisions 'on such enforcement policy considerations.'"[12]

Although Judge Kearse dissented from the result, her dissent focused solely on the issue of whether the predecisional CMS information was property under the applicable statutes. She disagreed with the court's finding that the planned CMS regulation was a "thing of value" susceptible to conversion because CMS adopts regulations subject to its own timetable regardless of whether information regarding the regulations is kept confidential or disclosed.[13] Similarly, she emphasized that CMS's interest in issuing a particular regulation on a particular date, or in keeping the regulation confidential until its issuance, did not constitute "property."[14]

Implications

First, the decision could have the impact of removing what had been understood to be an important limitation to the scope of insider trading liability—the requirement to show personal benefit and knowledge of the benefit—for some insider trading cases pursued by the prosecutors. This could expand the scope of potential criminal insider trading liability. Although the government will still have to demonstrate that the information at issue was property, the court's definition of property could be read to encompass many forms of inside information. After all, most sources of inside information take at least some steps to protect the information. Given that the court sanctioned the government's aggressive approach in this case, the government likely will continue to be aggressive in its insider trading enforcement and will use the full array of statutory powers.

Second, the decision reinforces the importance of paying attention to the separate powers of prosecutors and the SEC when navigating a parallel insider trading investigation. Although both can charge Title 15 securities fraud, each has unique powers. Only prosecutors can prosecute wire fraud and Title 18 securities fraud. Thus, the decision raises the possibility that there will be cases in which prosecutors have a basis to charge defendants and the SEC is not able to bring a civil case. But the SEC has a lower burden of proof and also has charges (such as failure to supervise) that prosecutors do not have authority to charge. The SEC also more frequently brings cases against firms for their failure to prevent insider trading. Indeed, in this case, the SEC charged the hedge fund (Deerfield Management Company L.P.) with violating Section 204A of the Advisers Act by failing to establish, maintain and enforce policies and procedures to prevent the misuse of inside information. Without admitting or denying the charges, Deerfield agreed to settle the case by agreeing to pay a total of $4.9 million in disgorgement and penalties and to cease and desist from future violations.

Third, the court's decision will likely be appealed, and the Supreme Court could weigh in again on the extent of the appropriate reach of the government's insider trading powers. As the parties acknowledged in their briefs, no other circuit court has addressed specifically the scope of the wire fraud and Title 18 securities fraud statute as applied to insider trading.

Fourth, and finally, the decision could affect the ongoing debate about whether to codify the prohibitions on insider trading. On December 5, 2019, the House passed the Insider Trading Prohibition Act that codified the insider trading prohibitions and important changes to existing law. The bill, however, does not purport to be an exclusive remedy for insider trading and, if passed, would not preclude prosecutors from continuing to use wire fraud and Title 18 securities fraud to address insider trading.

The authors would like to thank Law Clerk Emily S. Mannheimer for her assistance with the article.

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[1] No. 18-2811, 2019 WL 7289753 (2d Cir. Dec. 30, 2019).

[2] 773 F.3d 438 (2d Cir. 2014).

[3] 463 U.S. 646 (1983).

[4] *Blaszczak*, 2019 WL 7289753, at 19.

[5] *Id.* (citing *Carpenter v. United States*, 484 U.S. 19, 27 (1987)).

[6] *Id.* at 23.

[7] *Id.* at 27.

[8] *Id.* at 28.

[9] *Id.* (quoting *Dirks v. SEC*, 463 U.S. 646, 662 (1983)).

[10] *Id.* at 29.

[11] *Id.* at 32.

[12] *Id.* (quoting *United States v. O'Hagan,* 521 U.S. 642, 653–54 (1997)).

[13] *Id.* at 4 (Kearse, J. dissenting).

[14] *Id.* at 5–6 (Kearse, J. dissenting).

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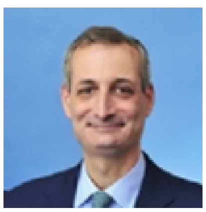

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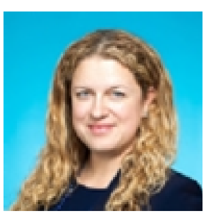

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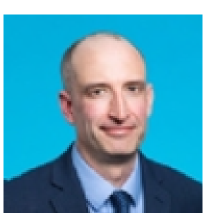

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