U.S. Supreme Court Vacates Second Circuit's Expansion of Criminal Insider Trading Liability

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On January 11, 2021, the U.S. Supreme Court vacated the 2019 decision of the U.S. Court of Appeals for the Second Circuit in *United States v. Blaszczak*,[1] which substantially broadened the scope of criminal insider trading liability, and remanded the case to the Second Circuit for further consideration in light of the Supreme Court's decision last year in *Kelly v. United States*.[2]

The Second Circuit held in *Blaszczak* that the government's often challenging burden under the Securities Exchange Act to prove that the insider received a "personal benefit" in exchange for tipping inside information, and that the insider's "tippees" were aware of that, does not apply to insider trading charges under the separate criminal securities fraud statute in Title 18 of the U.S. Code. *Blaszczak* thus brought about a potentially significant expansion of the circumstances in which trading on material non-public information may amount to criminal securities fraud. The Supreme Court's vacatur and remand to the Second Circuit call that expansion into question.

Blaszczak

Blaszczak involved the disclosure by employees of the Centers for Medicare & Medicaid Services (CMS) of nonpublic "predecisional" information about planned changes to reimbursement rates for certain medical treatments. The government's indictment alleged that the employees tipped David Blaszczak, a former CMS employee who was working as a political intelligence consultant at the time. Blaszczak, in turn, allegedly tipped three partners of a healthcare-focused hedge fund, which profitably traded on the information between 2009 and 2013.

The government charged Blaszczak, a CMS employee, and two of the hedge fund partners with Title 15 securities fraud under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, as well as securities fraud under 18 U.S.C. § 1348, a separate and seldom-used statute added to Title 18 by the Sarbanes-Oxley Act of 2002. (The U.S. Department of Justice (DOJ) can prosecute insider trading criminally under both the Exchange Act and Section 1348, while the SEC is limited to civil insider trading enforcement under the Exchange Act.) It also charged them with wire fraud under 18 U.S.C. § 1343. Sections 1343 and 1348 make it a crime to obtain fraudulently "any money or property" through interstate wires or in connection with a security, respectively.

The district judge instructed the jury that under *Dirks v. SEC*,[3] in order to convict the defendants of Title 15 securities fraud, it needed to find that the CMS insider disclosed the rate information in exchange for a personal benefit, and that Blaszczak and the hedge fund defendants knew that.[4] However, the court refused to give similar instructions on the Title 18 counts. The jury acquitted all defendants on the Title 15 counts, but convicted Blaszczak and the hedge fund defendants on the Title 18 charges. The defendants appealed their convictions to the Second Circuit on the grounds that (1) the predecisional CMS information was not "property" within the meaning of the Title 18 statutes, and (2) the district court erred in refusing to instruct the jury on the *Dirks* "personal benefit" test with respect to the Title 18 charges.

As to the first issue, the defendants argued that the predecisional information was akin to a state license, which the Supreme Court held in *Cleveland v. United States* not to be property under the federal mail fraud statute, because the state's interest in issuing the licenses (in that case, to operate video poker machines) was "purely regulatory" and not economic.[5] The Second Circuit disagreed, holding that the predecisional information constituted property because CMS possesses a "right to exclude" others from using it, similar to the right exercised by the *Wall Street Journal* over its "Heard on the Street" column, which the Supreme Court found to be property for insider trading purposes in *Carpenter v. United States*.[6]

On the second issue – whether the *Dirks* "personal benefit" requirement applies to Title 18 securities fraud – the Second Circuit again rejected the defendants' argument. The court reasoned that the courts created the personal benefit test in order to serve the specific statutory purpose of the Title 15 fraud provisions – namely, "eliminat[ing] the use of inside information for *personal advantage*" (emphasis in original). *Dirks*, the court explained, effectuated this purpose by holding that an insider could not breach his or her fiduciary duty by tipping unless the insider did so in exchange for a personal benefit. The court went on to conclude that this rationale does not apply to the Title 18 provisions, and noted that Congress enacted Section 1348 "to provide prosecutors with a different – and broader – enforcement mechanism to address securities fraud than what had been previously provided in the Title 15 fraud provisions[.]"[7]

Kelly

Kelly arose from the "Bridgegate" scandal, in which public officials ordered the closure of access lanes to the George Washington Bridge in Fort Lee, New Jersey in 2013 in order to punish the mayor of Fort Lee for refusing to support the former New Jersey Governor's reelection bid. (See our prior alert on the *Kelly* decision.) The defendants were convicted under the wire fraud statute as well as a separate statute prohibiting fraud on federally funded programs or entities (here, the Port Authority of New York and New Jersey), and the Third Circuit affirmed.

In a unanimous decision, the Supreme Court reversed the convictions, noting that both statutes require that the fraud have the objective of obtaining money or property, and not merely of deception. The government argued that it satisfied this requirement because the defendants used the paid labor of Port Authority employees to collect data about the lane changes in an effort to disguise their retaliation as a traffic study and to staff the one remaining tollbooth during overtime hours.

The Court, however, found that although the officials' conduct was deceptive and an abuse of power, the closure of the lanes was, at bottom, an "exercise of regulatory power," comparable to the issuance of licenses in *Cleveland*. Although their actions resulted in the expenditure of employee labor, the Court viewed this as "just the incidental cost of that regulation, rather than itself an object of the officials' scheme." Quoting its opinion in *Cleveland*, the Court emphasized that a state's regulatory "prerogatives over who should get a benefit and who should not" do not create a property interest.[8]

The Remand and Its Implications

It is as yet uncertain how the Second Circuit will rule on remand. The court may conclude that, under *Kelly*, the predecisional CMS information is merely a form of potential regulation, and thus beyond the reach of the fraud statutes at issue. (Indeed, its opinion in *Blaszczak* characterized the planned rate changes as "confidential information regarding contemplated regulatory action[.]"[9]) On the other hand, the court may distinguish the predecisional information from the lane closures in *Kelly* on the theory that CMS had a property interest in keeping the information confidential and controlling the timing of its public release, separate and apart from the regulatory act of adjusting the rates.

It is also unclear whether the Second Circuit will revisit its holding that the *Dirks* personal benefit test does not apply to Title 18. Even if it finds the CMS information not to constitute property under *Kelly*, the court may choose to reverse the convictions on that ground alone, leaving the door open for the government to continue to argue that it need not establish a personal benefit in its insider trading prosecutions under Sections 1343 and 1348.

We will continue to provide updates on *Blaszczak* and its implications for the scope of insider trading liability.

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[1] 947 F.3d 19.

[2] *Blaszczak v. United States*, No. 20-5649, 2021 U.S. LEXIS 353 (Jan. 11, 2021) (citing *Kelly v. United States*, 140 S. Ct. 1565 (2020)).

[3] 463 U.S. 646, 103 S. Ct. 3255, 77 L. Ed.2d 911 (1983).

[4] The Second Circuit held in 2014 that to convict the individual who traded on the information – or "tippee" – for insider trading under Title 15, the Government must proffer evidence that the tippee knew the tipper breached its duty in obtaining the information. *See United States v. Newman*, 773 F.3d 438, 447-49 (2d Cir. 2014), *abrogated on other grounds by Salman v. United States*, 137 S.Ct. 420 (2016).

[5] 531 U.S. 12, 121 S. Ct. 365, 148 L. Ed.2d 221 (2000).

[6] 484 U.S. 19, 108 S. Ct. 316, 9 L. Ed.2d 275 (1987).

[7] *Blaszczak*, 947 F.3d at 36-37 (citation omitted).

[8] *Kelly*, 140 S. Ct. at 1572 (citing *Cleveland v. United States*, 531 U.S. 12, 23 (2000)).

[9] *Blaszczak*, 947 F.3d at 32.
