Court rules that "personal benefit" not necessary for criminal insider trading liability under certain statutes

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A recent opinion by the US Court of Appeals for the Second Circuit may change the way the government pursues − and litigants defend − criminal insider trading cases across the country. On December 30, 2019, the Second Circuit held in *US v. Blaszczak et al.* that under criminal statutes contained in Title 18 of the US Code, including a general securities fraud provision enacted in the Sarbanes-Oxley Act (collectively, Section 18 fraud statutes), persons who provide material, nonpublic information (MNPI) − *ie,* “tippers” − and the recipients of that information who trade securities based on that MNPI − *ie*, “tippees” − can be held criminally liable even if the tipper did not receive a “personal benefit” from sharing the information. This contrasts to liability for insider trading *qua* securities fraud under Section 10(b) of the Securities Exchange Act of 1934 and the accompanying SEC Rule 10b-5 (Exchange Act liability), which continues to have a personal-benefit element.

Blaszcak thus makes it easier for the government to prosecute insider trading involving the securities of public companies under Title 18 as distinguished from the Exchange Act. While the court also decided another interesting issue (that a government agency’s confidential information may constitute “property” for insider trading purposes, a ruling on which one judge dissented), this alert focuses on *Blaszczak*'s insider trading analysis.

Exchange Act insider trading vs. Section 18 insider trading

No law explicitly prohibits "insider trading," but the government has for many years prosecuted individuals for insider trading under both the Exchange Act and Title 18. On the Exchange Act side − historically the more common route chosen by the government and, thus, the subject of considerably more case law − attorneys from the Department of Justice (which brings criminal cases) and the Securities and Exchange Commission (which brings civil cases) have brought insider trading cases under Section 10(b), which was enacted in 1934 and is part of Title 15 of the US Code. Section 10(b) prohibits "manipulative or deceptive device[s]" in connection with "the purchase or sale of any security," and the accompanying SEC Rule 10b-5 renders unlawful "any device, scheme, or artifice to defraud."

In the wake of the *Newman* decision, discussed below, prosecutors have increasingly started to bring cases pursuant to Title 18, under both the wire fraud statute (Section 1343) and Section 1348, a general securities fraud statute enacted in 2002 as part of Sarbanes-Oxley. Section 1343 makes it a crime when a person, "having devised or intending to devise any scheme or artifice to defraud," transmits "any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice…." (There is also similar prohibition in Section 1341, the mail fraud statute.) Section 1348 makes it a crime when a person "knowingly executes, or attempts to execute, a scheme or artifice … to defraud any person in connection with … any security" of an issuer that is registered with or files periodic reports with the SEC.

Thus, both the Exchange Act prohibitions and the Title 18 fraud statutes prohibit schemes or artifices to defraud. As the Second Circuit noted, the text of none of these proscriptions includes a personal-benefit element. On the Exchange Act side, the element emerged from a series of decisions going back to 1961. The SEC and courts first decided that trading on MNPI tipped by an insider of an issuer constitutes fraud under Rule 10b-5 and is a "deceptive device" under Section 10(b) based on a fiduciary duty principle that corporate officials cannot obtain a personal benefit from the information obtained through their service to the corporation. In *Dirks v. SEC*, the Supreme Court confirmed that a tipper must have received a personal benefit from his or her tip for the tippee to be liable. This "classical" theory was expanded in *US v. O'Hagan* into a generalized "misappropriation" theory prohibiting trading on MNPI obtained in breach of *any* duty of trust or confidence to the source of the information, not just a fiduciary duty to the issuer of the security. The personal benefit requirement has been applied in cases where a tippee did not herself misappropriate information, but rather traded on information misappropriated by the tipper.

The personal-benefit element has engendered substantial discussion. One reason why is because it can be difficult to define when a tipper receives a "personal benefit." For example, the SEC adopted Rule 10b5-2, which purports to provide a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the misappropriation theory. The definition includes "[w]henever a person receives or obtains [MNPI] from his or her spouse, parent, child, or sibling…." Courts have grappled with fact-intensive questions as to whether tips to family members necessarily provide a personal benefit, whether the same can be said of information provided between persons in other types of social relationships, and whether consideration other than money can constitute a benefit.

Another reason why the personal benefit requirement generates discussion is that it can be difficult for the government to prove that a tippee knew that a tipper tipped for a personal benefit (and not merely that there was a disclosure in breach of a duty of trust or confidence). This is especially salient where there are several intermediaries between the original source and the trader − *ie*, where a defendant is a remote tippee with no evident knowledge about the source. Under current law, the requirement that the government prove such knowledge on the part of the tippee (at least in a criminal Exchange Act prosecution) follows from a statutory *mens rea* requirement that the defendant must have acted "willfully." Thus, in *US v. Newman*, the Second Circuit reversed an insider trading conviction against traders four or five steps removed from the original corporate insider tippers, when the district court judge had declined to instruct the jury that the government must prove the traders knew that the insiders had disclosed confidential information for personal benefit.

The Supreme Court abrogated *Newman* on separate grounds (the circumstances under which there may be a personal benefit) in *US v. Salman*, but did not address the knowledge of personal benefit aspect of *Newman*. This had led to considerable continued debate about the elements of insider trading. For example, in *US v. Lee* (June 2019), a district court vacated a defendant's plea allocution made in 2013 as factually insufficient because it did not address whether the defendant knew the tipper had received a personal benefit, even though that issue had been discussed in *Newman*, *Salman*, and a subsequent leading Second Circuit case (*US v. Martoma*). *Newman* has also spurred efforts in Congress to define insider trading.

The uncertainties created by *Newman* have caused prosecutors to pursue more cases under Title 18, where the Supreme Court has not considered whether the personal-benefit element from Exchange Act jurisprudence applies. The government apparently recognized this gap because, after *Newman*, it increased the number of insider trading prosecutions under Title 18 as distinguished from Exchange Act-only claims.

The facts in *Blaszczak*

The question of whether Title 18 includes a personal-benefit requirement was squarely presented in *Blaczczak* because the jury acquitted the defendants of Exchange Act insider trading, as explained below.

Blaszczak involved a scheme to profit from advance knowledge of anticipated rulemaking by a government agency, the Centers for Medicare and Medicaid Services (CMS). CMS employees shared information about proposed and final rules for reimbursement rates for certain medical procedures with Blaszczak, a former CMS employee who was marketing himself as a political intelligence consultant. Blaszczak provided that information to hedge-fund employees. Knowing or understanding the likely source to be former colleagues of Blaszczak at the CMS, the hedge-fund employees then traded securities of companies that would be affected by the undisclosed future changes to reimbursement rates, realizing substantial profits.

The DOJ charged the defendants with, among other things, insider trading under the Exchange Act and the Title 18 fraud statutes. The judge instructed the jury that, pursuant to *Dirks*, the government had to prove that the original CMS employee-tipper received a personal benefit in exchange for his tips, and that the defendants knew this to be the case, to convict under Section 10(b). The jury acquitted the defendants on these charges.

The court, however, denied the defendants' request for a personal-benefit instruction on the Title 18 statutory charges. The defendants appealed their convictions under these statutes based on, among other things, the failure to give a personal-benefit instruction.

The Second Circuit decision

The Second Circuit affirmed the convictions by ruling that the personal-benefit element does not apply to the Title 18 fraud statutes. The opinion was authored by the district judge who had refused to instruct the jury that knowledge of a personal benefit was a requirement of Exchange Act criminal liability in *Newman*.

The court recognized that the Title 18 statutes, like the Exchange Act statute and rule, prohibit schemes to "defraud" and include insider trading in the ambit of fraud. The court also recognized that in each of these provisions, "the term 'defraud' encompasses the so-called 'embezzlement' or 'misappropriation' theory of fraud." The court decided, however, that this commonality of language did not matter and did not analyze the meaning of the Title 18 statutes by any principle based on their common statutory text.

Rather, according to the court, a scheme to defraud under Title 18 is different than a scheme to defraud under the Exchange Act because the statutes serve different purposes. The Exchange Act was enacted "to protect the free flow of information into the securities markets" while "eliminat[ing] use of inside information for personal advantage." The personal-benefit element recognized in *Dirks* had been derived by courts "entirely" to serve these purposes and could not be separated from its Exchange Act, securities-fraud context.

In contrast, the court continued, fraud under Title 18 is "derived from the law of theft of embezzlement," which may occur even without a breach of duty or the receipt of a personal benefit on the part of the embezzler. Moreover, according to two citations to the legislative history of the Sarbanes-Oxley Act, Congress enacted Section 1348 "in large part to overcome the 'technical legal requirements' of the Title 15 fraud provisions" and to "supplement the patchwork of existing technical securities law violations with a more general and less technical provision, with elements and intent requirements comparable to current bank fraud and health care fraud statutes."

The court also rejected what it characterized as defendants' attempts to interfere with Congressional policy prerogatives by "adding, in effect, a 'personal benefit' element to the Title 18 fraud statutes."

Implications

Blaszczak is unlikely to be the last word on insider trading. Apart from potential further appeals and decisions in other circuits, Congress already has been busy in this area. Indeed, in the same month *Blaszczak* was decided, a bipartisan majority of the House of Representatives passed a bill originally introduced in response to *Newman* that would enact the Insider Trading Prohibition Act to codify a ban on insider trading. While some might question why Congress went to all this trouble if (as *Blaszczak* asserts) it already had passed a broad prohibition against insider trading in 2002, Congress might decide otherwise and continue to legislate.

In the meantime, in the Second Circuit, *Blaszczak* expands and simplifies the DOJ's ability to prosecute insider trading. We anticipate this will encourage prosecutors to rely on Title 18 to prosecute insider trading to avoid the personal-benefit proof requirements of the Exchange Act. This does not mean the government's ability to pursue insider trading will be unlimited. For one thing, as the trial and appellate courts recognized in *Blaszczak*, criminal liability under the Title 18 statutes requires that the government prove (beyond a reasonable doubt) that a defendant "knowingly and willfully participated in the fraudulent scheme."   Moreover, Section 1348 applies only to public-company securities. Furthermore, the SEC cannot prosecute insider trading claims under the Title 18 statutes and the Exchange Act remains subject to the personal-benefit requirement.

Blaszczak should also serve as a warning to all investment advisors, hedge funds, and others relying on political intelligence. Those receiving and using information from such sources should implement compliance policies and procedures that vet the sources of information they receive in order to minimize the risk of civil and criminal insider trading investigations and prosecutions.

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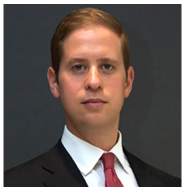

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