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Second Circuit curtails title 18 insider trading liability

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On December 29, 2022, the Second Circuit issued its highly anticipated opinion on remand in *United States v. Blaszczak* ("*Blaszczak II*"), reconsidering the case following the Supreme Court's January 2021 vacatur of the Second Circuit's original decision upholding multi-count convictions of defendants for, at bottom, illegally trading on material non-public information misappropriated from the government.

In two respects, the decision represents a challenge to the government's ability to make use of a recent — though largely untested — fraud statute in order to avoid the elements of traditional insider trading in criminal cases.

First, the decision makes it difficult in some cases for the government to use the more recent fraud statute, 18 U.S.C. § 1348, to avoid having to prove that the tipper received a personal benefit. Second, Judge John M. Walker, Jr.'s concurrence has questioned the fairness of having different elements under the new and traditional theories of liability at all, calling for further attention from reviewing courts and even Congress that could shut down prosecutors' easier path to liability under the more recent statute.

In this latest decision, a divided Second Circuit panel (1) granted the government's request to remand the cases to the district court to dismiss all but two of the convictions; and (2) concluded that since the verdict did not reveal whether the jury found that the charged conspiracy involved conduct other than that which the government no longer contends is criminal, vacated and remanded the remaining conspiracy convictions for reconsideration by the jury.

Neither outcome is, on its own, particularly surprising, especially since the Department of Justice had largely abandoned the theory of the government information as "property" that it had used to charge the case. But the road taken by the Second Circuit in reaching these outcomes is significant.

By adopting the DOJ's position and finding that, in the wake of the Supreme Court's ruling in *Kelly v. United States*, the government information at issue in *Blaszczak* was not "property" capable of sustaining a conviction under the applicable fraud statutes, the majority has narrowed the category of information that could trigger liability under the fraud statutes and created a distinction between how government information and privately held information may be prosecuted for insider trading.

Further, if Judge Walker's concurrence is successful in reigniting the debate over whether the personal benefit test should extend to Title 18 insider trading, there may no longer be much, if any, appeal to prosecutors using 18 U.S.C. § 1348 at all.

Background

As set forth in the Indictment, *Blaszczak* charged that a political intelligence consultant received nonpublic information concerning planned changes to Medicare reimbursement rates for particular drugs from a former colleague at the Center for Medicare and Medicaid Services ("CMS"), a government agency.

The consultant then shared that information with two hedge fund clients, who made millions of dollars trading in securities of companies that would be affected by the rate changes before the rates were released to the public. Notably, no one else involved in the scheme paid the former colleague at CMS for the information. Instead, the Government alleged that the CMS insider benefitted in less tangible ways.

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The Government charged the alleged conspirators with securities fraud offenses based on both Section 10(b) Securities Exchange Act of 1934 (the "Title 15" counts) and under Title 18 statutes, 18 U.S.C. § 1343 (wire fraud) and 18 U.S.C. § 1348 (securities fraud).

The Title 18 securities fraud statute was enacted in the wake of the 2008 financial collapse, and is distinct from the Title 15 statute, around which the Supreme Court and lower courts have, in *Dirks v. SEC* and other cases, developed the "personal benefits" requirement, under which the government must prove that a tipper received a personal benefit as part of the scheme.

The *Blaszczak* jury, presented with both Title 15 and Title 18 securities fraud counts, convicted on substantive Title 18 counts that did not require proof of a personal benefit, but acquitted on the substantive Title 15 counts.

In the Second Circuit's first *Blaszczak* decision ("*Blaszczak I*"), the court upheld the multi-count convictions of the defendants under the wire fraud and Title 18 securities fraud statutes.

In rejecting the defendants' challenge to their convictions, the Second Circuit concluded, in a 2-1 decision, that (1) confidential information taken from CMS was the government's "property" for the purposes of the statutes at issue; and (2) the "personal benefits" test established in *Dirks v. SEC* does not apply to the Title 18 fraud statutes, meaning the government does not have to prove the "personal benefit" element of the crime as required in bringing criminal or civil insider trading cases under the Securities Exchange Act.

The Court concluded that in light of the Supreme Court's decision in Kelly, *the substantive counts could not stand.*

Upon a further appeal, the U.S. Supreme Court remanded the case and ordered the Second Circuit to reconsider its decision in light of its intervening decision in *Kelly v. United States*.

In *Kelly*, the Supreme Court found that the conduct at issue in the so-called Bridgegate scheme (the shutdown of several lanes of traffic on the George Washington Bridge by members of then-New Jersey Governor Chris Christie's staff as an act of political retribution against a town mayor) was not the obtaining or conversion of government "property" for the purposes of the government's wire fraud theory, but rather principally an exercise of regulatory power, as the "time and labor of Port Authority employees" was "incidental" to the exercise of regulatory power involved. As a result, wire fraud and theft of government funds convictions for the Bridgegate conduct that were premised on fraudulently obtaining or converting property were vacated.

In April 2021, DOJ, in light of new, post-*Kelly* internal guidance, filed a remand brief in which it confessed error in light of the Court's *Kelly* decision and argued that all but two of the *Blaszczak* convictions should be reversed. The DOJ's new position on the "property" issue was now that "in a case involving confidential government information, that information typically must have economic value in the hands of the relevant government entity to constitute 'property' for the purposes of 18 U.S.C. §§ 1343 and 1348."

Though the DOJ maintained that CMS did have an economic interest in the confidential pre-decisional information used by the defendants, since the CMS employee time at issue was not an "object of the fraud," the DOJ conceded "the confidential information [in *Blaszczak*] does not constitute 'property' or a 'thing of value' under the relevant statutes after *Kelly*."

The DOJ's modified stance on the definition of "property" required the reversal of several convictions in *Blaszczak*. Left unresolved was whether the Second Circuit would revisit and clarify the other elements required to prove insider trading under a wire fraud theory, especially since the Supreme Court's remand did not explicitly call for the personal benefit test to be revisited. A concurring opinion in *Blaszczak I* had expressed concerns in dicta regarding the government's use of the Title 18 insider trading statute without needing to prove the "personal benefit" element.

The Second Circuit's decision

In the majority decision, Judge Amalya Kearse first addressed the DOJ's confession of error and argument in favor of the reversal of the seven substantive counts in the underlying case. While acknowledging that the government's confession of error did not "automatically" govern the Second Circuit's decision, the Court concluded that in light of the Supreme Court's decision in *Kelly*, the substantive counts could not stand.

As explained by the Second Circuit, *Kelly* made clear that the "objective of [the defendants'] schemes and conduct" must be the money or property of the government agency for it to qualify as "property" under the governing statutes.

However, because the government agency at issue was not a commercial entity ("it does not sell, or offer for sale, a service or product"), the timing of its benefit decisions were fundamentally regulatory in nature and thus could not constitute a "thing of value" that may be "converted." As a result, the Second Circuit concluded that the government could not establish that the objective of the defendants' schemes was the "property" of CMS, thereby warranting dismissal of all of the substantive counts.

As to the remaining conspiracy counts, which include conspiracy to convert property belonging to the United States, to commit Title 15 securities fraud, and to defraud the United States, the Second Circuit noted that the jury was not provided questions to answer that revealed which of the enumerated goals of the conspiracy it found that the government had proven.

The full array of "intangible" property interests that can give rise to fraud and theft charges seems somewhat unsettled.

While the government argued that any error in this lack of clarity was harmless, the Second Circuit disagreed, concluding that the absence of clarity as to whether the basis was the no-longer valid conversion of "property" required the convictions to be vacated and that those counts against the defendants be remanded for resubmission to the jury.

In his concurring opinion, Judge Walker voiced concerns surrounding the holding in the *Blaszczak I* decision that criminal liability under § 1348 does not require proof that the tipping individual receive a personal benefit despite the fact that the government would be required to show that a personal benefit was received in civil Title 15 securities fraud cases.

Judge Walker noted that "traditional notions of fair play are offended by the present incongruence in this circuit between civil and criminal deterrence," and emphasized that it should not require fewer elements to prove a criminal conviction than to impose civil penalties for the same conduct. The concurrence urged the larger Circuit, the Supreme Court, and Congress to attend to this asymmetry.

In a strongly-worded dissent, Judge Richard J. Sullivan criticized the majority's conclusion regarding the inapplicability of the fraud statutes as required by neither the statutes themselves nor the Department of Justice's decision to abandon much of its case in light of *Kelly*.

With respect to the former, Sullivan pointed out that *Blaszczak II*'s majority was in tension with the Supreme Court's decision in *Carpenter v. United States*, which upheld a property right in intangible confidential information held by the *Wall Street Journal*, and that *Kelly* did not actually call for a distinction between schemes that affect regulatory choices and schemes that affect property interests.

The dissent also criticized Judge Walker's analysis of whether 18 U.S.C. § 1348 requires a "personal benefit" as "gratuitous" and "advisory," in addition to being wrong on the merits. Judge Sullivan noted that the personal benefit test is a judge-made rule with its genesis in the statutory purpose of the Securities Exchange Act of 1934, origins that § 1348 does not share.

Implications

At a minimum, *Blaszczak II*'s judicial enshrinement of the DOJ's narrowed view of what constitutes government "property" under the fraud statutes and its broad view of *Kelly* renders Title 18 largely inapplicable to prosecuting theft of government information.

Cases in the mold of *Blaszczak* — which may include trading on predecisional information about budgetary decisions, government healthcare decisions, tax policies, or economic stimulus plans — will have to be charged under Title 15, and will therefore be subject to the well-defined case law that the courts have developed over the course of many years. More broadly, the full array of "intangible" property interests that can give rise to fraud and theft charges seems somewhat unsettled after *Blaszczak II*.

The distinction now created between private and government property interests could well give rise to similar distinctions not immediately apparent from the text of the fraud statutes.

As for the personal benefit test, whether Title 18 securities fraud continues to remain free from the strictures that developed around its Title 15 counterpart may depend upon whether Judge Walker's reasoning finds an audience in Congress, the Supreme Court, or an *en banc* Second Circuit. *Blaszczak* itself demonstrates the significance of the personal benefit requirement, given the jury's decision to convict only on the Title 18 counts that did not require such a finding.

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