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Expert Analysis

The Significance of 'U.S. v. Blaszczak' For Insider Trading Prosecutions

By **Antonia M. Apps**

On May 24, 2017, the U.S. Attorney's Office for the Southern District of New York (USAO) and the Securities Exchange Commission (SEC) announced parallel insider trading charges against a Washington, D.C.-based "political intelligence" consultant, the government employee who had been his alleged source of inside information, and three hedge fund analysts whom he tipped. One of the analysts pled guilty earlier in the month and is cooperating with the government.[1] The case marks the second time the government has brought insider trading charges against a "political intelligence" consultant. But the case is significant for another reason. An analysis of the alleged "benefit" to the tipper shows that there are notable similarities to facts in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), which signals that the government is confident that the recent Supreme Court decision in *Salman v. United States* has overruled the Second Circuit's personal benefit holding in *Newman* in its entirety. On a practical note, the case also underscores the need for investment professionals who rely on political intelligence firms to monitor the source of the information they receive from those firms and to assess carefully any potentially material nonpublic information emanating from government agencies before trading.

The Benefit to the Tippers in 'Blaszczak' and 'Newman' Compared. The government alleged that David Blaszczak, a former employee at the Centers for Medicare & Medicaid Services (CMS) turned consultant for various "political intelligence" firms, obtained information from a former CMS colleague, Chris Worrall. Worrall, who had access to CMS's confidential deliberations about unannounced and potentially market-moving reimbursement decisions, allegedly divulged to Blaszczak that

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the CMS planned (1) to cut reimbursable treatment times for two cancer procedures, and (2) to cut

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reimbursement rates for various kidney dialysis treatments, services and drugs by 12 percent. Blaszczak, in turn, passed the information to the hedge fund analysts, who caused their hedge fund to sell short based on the information.

The indictment describes Worrall as a "close friend" of Blaszczak. Indictment ¶ 21. It alleges that "Worrall frequently discussed private-sector employment and other business opportunities" with him. Id. ¶22. Specifically, Blaszczak put Worrall in contact with another political intelligence consultant so that Worrall could interview for a private sector job with the consultant's firm. Id. Worrall commented to a family member that working for the consultant could be a "big opportunity" because of the consultant's "political links." Id. Worrall did not take the job, but (according to the SEC complaint) nevertheless used the opportunity to leverage a promotion at CMS that included a $10,000 pay raise. Complaint ¶ 5. Another time, Blaszczak asked Worrall to become a "part owner" of a new political intelligence firm that Blaszczak was starting. Blaszczak told Worrall that he was on pace for "1.7 million total revenues for 2014" and that if Worrall joined him, they would "kill it working together." Indictment ¶ 22. Worrall responded, "You're like a drunk whore to me. Hard to resist. Lol. Let's talk." Id. Finally, Blaszczak introduced Worrall to Senate staff members for purposes of professional networking, which Worrall appreciated. Id. ¶ 46.

In *Newman*, the defendants were tippees three and four levels removed from a tipper who worked at Dell.[2] The Dell tipper, Rob Ray, disclosed Dell's unannounced top-line earnings numbers to Sandeep Goyal several quarters in a row. Goyal had left Dell to take a more lucrative analyst job at a Wall Street investment firm, and Ray wanted to follow in Goyal's footsteps. While Goyal declined to call Ray a "close" friend, they had met each other's wives, had dinner together, and talked about going on joint vacations. Ray told Goyal that he was "desperately looking to break into the buy/sell side" and sought out Goyal's advice and assistance. Goyal helped Ray with preparing for an industry examination, provided feedback on Ray's resume and sent it to a Wall Street recruiter, and told Ray that he had "put in a good word" for Ray with a buy-side person Ray wanted to interview with. Goyal also provided Ray with a stock pitch that he could use in job interviews. To be sure, Goyal provided career advice to others; but he testified that he provided more detail and spoke more frequently and for longer periods of time with Ray than anyone else, and the phone records showed dozens of calls with Ray, many lasting an hour or more. Goyal also testified that he would not have engaged in these lengthy conversations absent getting the inside information from Ray. Like Worrall, however, Ray never in fact successfully transitioned to a Wall Street firm.

Both cases also involved substantial benefits to the first level tippee. Blaszczak allegedly received more than $263,000 in consulting fees from the hedge fund analysts he tipped, which included a $29,000 discretionary bonus based on Blaszczak's "work on [the cancer treatment information]," given Blaszczak was "100%" responsible for the successful trade based on the information. Newman authorized his firm to pay Goyal $175,000 under a sham consulting agreement with Goyal's wife, which included a $100,000 bonus because, in Newman's words, Goyal "helped us most," referring to the Dell tips passed on by Goyal.

The defendants were convicted at trial, but their convictions were vacated on appeal: the Second Circuit found the evidence of personal benefit insufficient.

How Much of Personal Benefit Test of 'Newman' Survives 'Salman'? The court in *Newman* instituted a new test: "To the extent [*Dirks v. SEC*[3]] suggests

that a personal benefit may be inferred from a personal relationship between the tipper and tippee, where the tippee's trades 'resemble trading by the insider himself followed by a gift of profits to the recipient,' see *Dirks*, 643 U.S. at 664, we hold that such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." The second part of this test—the need for the tipper to receive something of a "pecuniary or similarly valuable nature"—was rejected by a unanimous Supreme Court nearly two years later in *Salman v. United States*, 137 S. Ct. 420, 428 (2016). *Salman* affirmed *Dirks*' gift-giving analogy, but because *Salman* involved tipping between brothers who were concededly "very close," the question remains post-*Salman* whether *Newman*'s requirement of "proof of a meaningfully close personal relationship" is still good law. In other words, is any friendship (or familial relationship), no matter how close, sufficient to establish liability under *Dirks*' gift-giving principle?

The Second Circuit will likely address the personal benefit test again soon. In *U.S. v. Martoma*, a doctor involved in clinical drug trials engaged in paid consulting calls with the defendant, a hedge fund portfolio manager, in which he discussed the confidential trial. On one occasion, however, the defendant met with the doctor in person, without being paid, and it was in that session (according to the defendant) that he obtained the inside information that he traded on. The *Newman* decision was handed down after the trial, and Martoma has argued that he and the doctor and were not sufficiently "close" to meet *Newman*'s "meaningfully close personal relationship" test, which was not overruled by *Salman*. The government contends that *Salman* overruled both aspects of the *Newman* test—the pecuniary gain and close personal relationship requirement—because the Supreme Court did not engage in any analysis of whether the brothers were "meaningfully close," and because there was no distinction drawn between "family" or "friends" in the court's discussion of *Dirks*' gift-giving analogy. The Second Circuit appears focused on the personal benefit issue given that just last month it heard a second oral argument in the case after receiving additional briefing on the *Salman* decision.

A decision by the Second Circuit in *Martoma* could shed light on the standard the government will need to meet at trial with respect to the "closeness" of the relationship between Worrall and Blaszczak. But the fact the indictment does not go into greater detail as to that relationship suggests that the government may be taking the position that *Newman*'s personal benefit holding has been (or will be) entirely overruled.

The Lasting Impact of 'Newman': Tippee Knowledge of Personal Benefit. *Newman* had a second, important holding for insider trading cases, which has not been impaired by the *Salman* decision: that a downstream tippee must have knowledge that the original tipper—who may be three or four people removed—received a personal benefit in exchange for the disclosure of confidential information. In *Newman*, the government charged the portfolio managers who made the trading decisions based on the recommendations of their analysts. In *Blaszczak*, the government charged the hedge fund analysts who made the recommendation, but not the managing partner responsible for approving all investment decisions (identified as "CC-1" in the indictment). Even as to the hedge fund analysts, however, there are scant allegations regarding their knowledge of any benefit to Worrall, the insider. The indictment alleges that the analysts were aware that Blaszczak had a source at CMS and the

SEC complaint offers only that they should have known Blaszczak was friendly with CMS employees.

In *Newman*, the portfolio managers were also told that the information came from an insider at Dell. They were not told—and did not ask for—the insider's name or position at Dell, despite betting hundreds of millions of dollars on the information for several quarters in a row.[3] Yet the Court of Appeals held there was insufficient evidence to support a finding of tippee knowledge of the tipper's breach of duty in exchange for a personal benefit.

Of course, in *Blaszczak*, we have only unproven allegations to go on. The government may present additional evidence of knowledge of the benefit (or rely on a conscious avoidance theory) at trial, but failing that proof, the case is poised to test the limits of the application of *Newman*'s second holding on tippee knowledge.

The Government's Recent Focus on Political Intelligence Cases. Bringing cases against government employees who leak confidential agency information is not new (albeit it is rare),[4] but the recent focus on the political intelligence industry suggests that hedge funds and investment professionals that use such firms should be careful to scrutinize the sources of the information they receive from them. In 2015, the SEC sanctioned a political consulting firm because it encouraged employees to maintain their contacts with former colleagues at government agencies (and sought to hire former government employees with such contacts), without sufficient safeguards regarding the receipt of potential material nonpublic information.[5] Significantly, the SEC noted that the firm's policies and procedures did not expressly require the compliance department to be advised as to the source of the information included in the research note. The revolving door aspect of the political intelligence firms seems to have drawn the SEC's ire in *Marwood*, and the *Blaszczak* case underscores that the government is willing to bring charges against downstream tippees where there is evidence they knew that the confidential information came from inside a government agency.

Conclusion

Blaszczak demonstrates the government's willingness both to pursue political intelligence insider trading cases and its confidence that the Second Circuit's decision in *Newman* on personal benefit has been overruled. But securities fraud charges were not the only charges brought against the defendants in the *Blaszczak* indictment. The government also charged the defendants with stealing confidential information (the value of which allegedly exceeds $1,000) from CMS in violation of 18 U.S.C. §641 (embezzlement of government property). Perhaps the government wanted to hedge its own bullish interpretation of the scope of the overruling of *Newman*.

1. See *U.S. v. Blaszczak*, 17 Cr. 308 (DLC) (S.D.N.Y. May 24, 2017); *S.E.C. v. Blaszczak*, 17-cv-03919, 2017 WL 2266005 (S.D.N.Y. May 24, 2017).
2. Some of the facts set forth herein were not included in the Second Circuit's opinion, but are set forth in the government's briefing in the Second Circuit and the Supreme Court. See, e.g., U.S. Petition for Writ of Certiorari, *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014) (Nos. 13-1837-cr , 13-1917-cr), at 4.
3. Additionally, Newman was told that the information could only be obtained from the insider at night and on weekends, indicating that the insider was not authorized to divulge the information.
4. In 1988, then-U.S. Attorney for New Jersey, Samuel A. Alito, Jr. charged a former director of the New York Federal Reserve Bank with leaking planned changes in the Federal Reserve's discount rate to a New Jersey securities firm. See A Former Official of Federal Bank Indicted as an Insider, Joseph Sullivan, NY Times (Dec. 9, 1988).
5. *In the Matter of Marwood Group Research*, U.S. Securities and Exchange Commission, SEC Docket, Vol. 112, No. 18 (Nov. 23-27, 2015).

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