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Can the Government Circumvent "Newman's" Personal Benefit Test?


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On Thursday, Nov. 21, 2019, the U.S. Court of Appeals for the Second Circuit heard argument in *United States v. Blaszczak*—an insider trading case that could upend decades of judicial precedent defining the crime of insider trading. Much ink has been spilled over the fact that there is no statute specifically outlawing insider trading. Instead, 40 years of judicial precedent has attempted to define when trading on material nonpublic information constitutes a "fraud" under the catchall antifraud provision of the Securities Exchange Act of 1934, Section 10(b) and SEC Rule 10b-5 (referred to herein as Title 15). Title 15 has been interpreted to require the government to prove that a tipper disclosed material nonpublic information in breach of a fiduciary duty and in exchange for a "personal benefit." The personal benefit test originated in the Supreme Court case *Dirks v. SEC*, 463 U.S. 646 (1983), but the element has come into sharp focus in recent years following the Second Circuit's 2014 decision in *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014), which tried to introduce a more stringent personal benefit test. Although *Newman*'s holding has been substantially overruled by the Supreme Court, (see *Salman v. United States*, 137 S.Ct. 420 (2016)), as being in contravention of *Dirks*, as well as subsequent Second Circuit decisions (see *United States v. Martoma*, 894 F.3d 64 (2d Cir. 2017)), the uncertainty surrounding the personal benefit requirement has created problems for prosecutors and defense lawyers alike. This "shoddy state of American insider-trading law," as a former U.S. Attorney for the Southern District of New York has decried, has led to the creation of a task force whose mission is to craft a workable insider trading statute. Preet Bharara & Robert Jackson Jr., Insider Trading Laws Haven't Kept Up With the Crooks, N.Y. Times, Oct. 9, 2019. (One of this article's authors, Katherine Goldstein, is a member of the Bharara Task Force on Insider Trading.) In the meantime, government prosecutors are attempting to circumvent the personal benefit element altogether by charging alleged insider trading under the wire and securities fraud statutes in Title 18 of the U.S. Code.

United States v. Blaszczak marks the first time the Second Circuit will have the opportunity to address whether the government can criminally prosecute insider trading under Title 18 without proving personal benefit to the tipper since the element was imposed on Section 10(b) by the Supreme Court in *Dirks*. In *Blaszczak*, the tipper, a government employee, and tippees were charged with violating both Section 10(b) and with wire and securities fraud under 18 U.S.C. §§1343 and 1348. Although not discussed herein because it will have application only to political intelligence cases where the information emanates from the government, the Department of Justice also charged conversion of

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government property in violation of 18 U.S.C. §641.

The jury instructions on the Title 18 wire and securities fraud counts notably omitted any reference to personal benefit. After a four-week trial, the defendants were *acquitted* of the Title 15 charges, but convicted on the Title 18 charges. That verdict, which likely reflects the government's failure to prove personal benefit beyond a reasonable doubt, could cause the Securities and Exchange Commission to dismiss its pending (but stayed) parallel action under Section 10(b), exposing the odd state of play that the government's new charging strategy will create. If the government is successful on appeal, it will produce the anomalous result that individuals—whether company insiders or investment professionals—could be held *criminally* liable for insider trading while escaping *civil* liability because the primary enforcement regulator charged with policing the securities markets will be powerless to bring any insider trading action against them.

'United States v. Blaszczak'

In *Blaszczak*, an employee of the Centers for Medicare and Medicaid Services (CMS), Christopher Worrall, Allegedly provided nonpublic information about prospective changes to Medicare reimbursement rates for radiation oncology and kidney dialysis treatments to his friend and former CMS employee, David Blaszczak. Blaszczak, a political intelligence consultant, in turn provided the confidential information to three analysts at his client Deerfield Management Company, L.P. Deerfield executed profitable trades in health care companies that were impacted by the proposed rate cuts and realized gains of over $7 million. While Blaszczak received compensation through his firm's consulting arrangement with Deerfield, the CMS tipper—Worrall—did not receive any money. The only "benefits" he received were free meals and tickets to sporting events, and an opportunity to work at the consulting firm where Blaszczak worked, which Worrall ultimately turned down.

The jury instructions for the Title 15 securities fraud charge, which spanned 14 pages of transcript and required the jury to march through 10 separate elements, provided that the government had to prove that Worrall owed a duty of trust and confidence to his employer, that he breached that duty by revealing material nonpublic information, that he did so for a personal benefit, and that each tippee knew of those facts. The court provided a lengthy definition of personal benefit, including that it "need not be financial" and could be "the benefit one would obtain from simply making a gift … to a relative or friend."

> If the 'Blaszczak' court affirms the Title 18 wire and securities fraud convictions, it will significantly alter the landscape for insider trading liability.

In sharp contrast, for the Title 18 wire and securities fraud charges, the jury instructions took up fewer than five pages of the transcript. The government had to prove that the defendants knowingly executed a scheme to defraud, which was satisfied by a defendant's participation in a "scheme to embezzle or convert confidential information from CMS by wrongfully taking that information and transferring it to his own use or the use of someone else." In its charge, the district court explained that an "act of embezzlement" is "a fraudulent appropriation to one's own use of the money or property entrusted to one's care by someone else." Neither personal benefit to the tipper nor knowledge of that benefit by the tippee were elements of the charge.

Arguments on Appeal

The appellants' principal argument on the Title 18 wire and securities fraud counts is that the government cannot use those statutes as an end-run around the doctrinal limitations that courts have developed for insider trading under Section 10(b) over the past forty years. Because Sections 1343 and 1348 contain the same operative fraud language as Section 10(b), the same elements that apply under Title 15 must apply under Title 18. In particular, since the Supreme Court in *Dirks* held that there can be no insider trading liability under Section 10(b) absent deception, and there is no deception without a breach of fiduciary, which in turn requires a personal benefit to the tipper, then a personal benefit must likewise be required under Title 18.

The government's central claim in *Blaszczak* is that the Section 10(b) personal benefit and knowledge-of-benefit elements should not be engrafted onto Sections 1343 or 1348—which was enacted in 2002 in the wake of the Enron scandal but modeled on the wire fraud statute—when those elements neither appear in the text nor are required under typical wire fraud instructions applicable to other types of frauds. The government's theory is that insider trading under wire fraud (and Section 1348 securities fraud) is akin to embezzlement, and "[c]onverting property to one's own use, as required for embezzlement, does not necessarily mean benefitting personally from the conversion; it means simply putting the property to a use other than the one for which it was entrusted (which can, of course, and often does, benefit the misappropriator personally)." Govt. Br. at 59.

The government relies heavily on *Carpenter v. United States*, 484 U.S. 171 (1987), the Second Circuit's analysis of which could determine the outcome in *Blaszczak*. In *Carpenter*, the *Wall Street Journal* author of its highly successful "Heard on the Street" column—which could impact stock prices when released—leaked the "timing, content and tenor" of the columns to tippees who traded on the information and shared the profits with the tipper. The tipper and tippees were charged with both Section 10(b) and mail and wire fraud under Title 18. Following a bench trial, the district court found the defendants guilty under both statutes. But the Supreme Court, at the time comprised of eight justices, was evenly divided on whether Section 10(b) could extend beyond the so-called "classical theory" endorsed in *Dirks* (i.e., where the tipper owes a duty to the company whose stock is traded) to "misappropriation" cases (where the tipper owes a duty to the source of the information but not the company). The misappropriation theory under Title 15 was not approved by the Supreme Court until *United States v. O'Hagan*, 521 U.S. 642 (1997), decided 10 years later. However, the Supreme Court in *Carpenter* had no trouble affirming the mail and wire fraud convictions, finding that the Journal's interest in the confidentiality of the contents and timing of its "Heard" column constituted property, and that the concept of "fraud" included "the act of embezzlement, which is the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another." 484 U.S. at 27 (internal quotations and citation omitted).

How Do You Get Around 'Carpenter'?

At oral argument, this was the question asked of defense counsel who argued that the definition of fraud should be applied consistently across all the fraud statutes when it comes to insider trading. To be sure, the court in *Carpenter* allowed mail and wire fraud convictions to stand when there was no consensus on Section 10(b) liability. But that point only carries the argument so far. While *Carpenter* endorsed an embezzlement theory, it also grounded its holding in a breach of fiduciary duty for personal gain. The court observed that "a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit … ." 484 U.S. at 27-28. The government dismisses such statements as "red herrings," Govt. Br. at 59, but any doubt as to the significance of the "personal benefit" language in *Carpenter* was surely resolved in *O'Hagan*. There, the Supreme Court described Section 10(b)'s misappropriation theory as "fraud of the same species" as *Carpenter*'s mail and wire fraud embezzlement theory. 521 U.S. at 654. The Supreme Court then incorporated the personal gain language into the definition of the misappropriation theory, observing that "misappropriators … deal in deception. A fiduciary who pretends loyalty to the principal while secretly converting the principal's information for personal gain … 'dupes' or defrauds the principal." Id. at 653-54 (citations omitted). In holding that *Carpenter*'s embezzlement theory was the *same* as the Section 10(b) misappropriation theory, *O'Hagan* suggests that insider trading by misappropriation, whether under Section 10(b) or Title 18 wire or securities fraud, must contain the breach-for-personal-benefit element in order to qualify as fraud. Given that several cases in the Second Circuit have now held that the elements of tipping liability are the same regardless of whether the tipper's duty arises under the classical or misappropriation theories, see, e.g., *Martoma*, 894 F.3d at 73; *Newman*, 773 F.3d at 446; *SEC v. Obus*, 693 F.3d 276, 288 (2d Cir. 2012), it is difficult to reconcile how converting property for one's own use can substitute for the personal benefit requirement established under *Dirks* for insider trading liability, regardless of which fraud statute is employed. At oral argument, the government acknowledged this weakness in its position, attributing the anomaly to the "peculiar history of the [Section] 10(b) jurisprudence."

Conclusion

If the *Blaszczak* court affirms the Title 18 wire and securities fraud convictions, it will significantly alter the landscape for insider trading liability. As one amicus brief (on behalf of law professors) pointed out, the lower court's Title 18 instruction would render Title 15 obsolete as a tool in the criminal authorities' arsenal against insider trading. At oral argument, the government appropriately declined to comment on future charging decisions, but it would be surprising if prosecutors would prefer a jury charge with 10 separate steps over a simple wire fraud charge that avoids proof of personal benefit. Should prosecutors make such a seemingly rational charging decision, we may see the perverse result being that criminal charges are brought without parallel civil charges, or that civil and criminal charges are brought under different statutes with different elements. In that circumstance, market participants and compliance professionals will be left yet again to wonder where the lines have been drawn, and the case for an insider trading statute to fix these anomalies will be even more compelling.