BakerHostetler

Second Circuit Upholds Title 18 Insider-Trading Conviction Where Title 15 Elements Not Established: Will Prosecutors Take Advantage?

By Matthew Feil and Andrew Serrao

Feb. 1, 2020

The recent decision in *United States v. Blaszczak* may signal a change in how prosecutors in the Second Circuit, and perhaps in other jurisdictions, pursue insider-trading cases. --- F.3d ----, Nos. 18-2811, 18-2825, 18-2867, 18-2878, 2019 WL 7289753 (2d Cir. Dec. 30, 2019). In *Blaszczak*, the United States Court of Appeals for the Second Circuit held that insider-trading under Title 18 of the U.S. Code does not involve the same "personal benefit" test the Supreme Court applied to insider-trading under Title 15 in *Dirks v. SEC*, 463 U.S. 646 (1983). The *Blaszczak* decision arguably provides the government with an avenue to avoid the Supreme Court's ruling in *Dirks* and could embolden prosecutors to charge defendants more aggressively with insider trading under Title 18. But while *Blaszczak* relieves the government of the "personal benefit" test, prosecutors will likely still have to show a defendant defrauded a victim of "property" under 18 U.S.C. § 1348. This "property" requirement, which does not apply to Title 15's insider-trading provisions, may continue to limit how aggressively the government employs Title 18 to prosecute such cases.

The *Blaszczak* Facts

David Blaszczak, a former employee at the Centers for Medicare & Medicaid Services ("CMS") turned hedge fund consultant, obtained non-public, so-called predecisional information about anticipated rule changes from sources at CMS. Blaszczak tipped this information to traders at certain hedge funds who then traded on it before CMS publicly announced the rule changes.

The government charged Blaszczak with securities fraud under both Title 15 and Title 18, among other things. In May 2018, a jury found Blaszczak guilty of securities fraud in violation of 18 U.S.C. § 1348 ("Title 18 securities fraud"), but acquitted him of securities fraud under 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5 ("Title 15 securities fraud"). He was sentenced to over twelve months imprisonment and ordered to forfeit over $700,000.

Blaszczak appealed his conviction, arguing that *Dirks* required the government to prove that the CMS insiders revealed non-public information to Blaszczak in exchange for a "personal benefit." In doing so, Blaszczak sought to import a longstanding requirement for Title 15 securities fraud to Title 18 securities fraud. Because the evidence failed to prove that the CMS insider disclosed non-public information to Blaszczak in exchange for a personal benefit, Blaszczak argued that he should also have been acquitted of Title 18 securities fraud.

The "Personal Benefit" Requirement Under *Dirks*

Blaszczak's appeal relied largely on the Supreme Court's 1983 decision in *Dirks*. Robert Dirks, an investment adviser and officer of a broker-dealer, received non-public information about a potential fraud at a financial conglomerate. Dirks shared this non-public information about fraud with clients and other investors, who in turn traded on the information. After the fraud became public, the SEC brought a disciplinary proceeding against Dirks, finding that he aided and abetted Title 15 securities fraud.

The Supreme Court disagreed, holding that Dirks was not liable under Title 15 because the insider who tipped him did not receive a "personal benefit" for disclosing the non-public information. The Court reasoned that for Dirks to be liable, the insider must have breached a fiduciary duty in disclosing the information about the fraud to Dirks. Whether the disclosure was a breach of duty, the Court explained, "depend[ed] in large part on the purpose of the disclosure," and accordingly, "the test is whether the insider personally will benefit . . . from his disclosure." *Dirks*, 463 U.S. at 662. The Court reasoned that a "'significant purpose of the Exchange Act was to eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office.'" *Dirks*, 463 U.S. at 653 n.10 (quoting *In re Cady, Roberts & Co.*, Exchange Act Release No. 34-6668, 1961 WL 60638, at *4 n.15 (Nov. 8, 1961)). The insider who tipped Dirks received no monetary or personal benefit for his disclosure and was instead motivated by a desire to expose the fraud. Dirks, therefore, was not liable for Title 15 securities fraud.

The *Blaszczak* Holding

The Second Circuit declined Blaszczak's invitation to import the *Dirks* personal-benefit test to Title 18 securities fraud because of the differing statutory purposes of Title 15 and Title 18 securities fraud. In so doing, the court presumably provided an avenue for prosecutors to avoid the *Dirks* personal-benefit requirement. That avenue, however, may be relatively narrow because under § 1348, the government likely must show that the defendant defrauded a victim of "property."

The court first noted three similarities between the Title 15 and Title 18 securities fraud provisions. First, none of those provisions explicitly mentions a "personal benefit" test. Second, they all prohibit schemes to defraud in connection with the purchase or sale of securities. Third, each provision's concept of fraud includes 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.'" *Blaszczak*, 2019 WL 7289753 at *8 (quoting *Carpenter v. United States*, 484 U.S. 19, 27 (1987)).

Despite these similarities, the court focused on the differing purposes behind Title 15 and Title 18. It noted that the personal-benefit test is a judge-made doctrine intended to effectuate the purpose of the Securities Exchange Act of 1934 and its Title 15 fraud provisions by protecting the free flow of information in the securities markets. It thus allows people to profit from generating information about firms that promotes the efficient pricing of securities while "'eliminat[ing] [the] use of inside information for *personal advantage*.'" *Blaszczak*, 2019 WL 7289753 at *8 (quoting *Dirks*, 463 U.S. at 662). But the personal-benefit test, the Second Circuit noted, is not grounded in the embezzlement theory of fraud and instead "depends entirely on the purpose of the Exchange Act[.]"

Title 18 securities fraud, by contrast, has a different and broader purpose. The court found that Congress intended for 18 U.S.C. § 1348 to provide prosecutors with a broader mechanism to address securities fraud. Specifically, Congress enacted 18 U.S.C. § 1348 in 2002 as part of the Sarbanes-Oxley Act largely to overcome the "'technical legal requirements'" of Title 15 securities fraud. *Blaszczak*, 2019 WL 7289753 at *9 (quoting S. Rep. No. 107-146, at 6 (2002)). Indeed, § 1348 was meant to "'supplement the patchwork of existing technical securities law violations with a more general and less technical provision[.]'" *Blaszczak*, 2019 WL 7289753 at *9 (quoting S. Rep. No. 107-146, at 14).

But does *Blaszczak* provide an end around the personal-benefit test, and with it the policy concerns underlying the Supreme Court's application of the test to Title 15 securities fraud in *Dirks*? The answer to that question remains unclear at this point. The Second Circuit explicitly declined to consider this policy question when interpreting the meaning of Title 18's fraud provisions. Such questions, in the court's estimation, are the sole jurisdiction of Congress and the Executive.

It is worth noting, however, that Dirks' conduct would not likely be actionable securities fraud under Title 18. Unlike Title 15, § 1348(2) requires that a person obtain "money or property" by means of false or fraudulent pretenses. And while § 1341(1) (which can support a conviction on its own) does not explicitly mention "property," the *Blaszczak* court assumed the "property" requirement still applied there because the government did not dispute that the object of a scheme to defraud could be anything other than "property." Thus, prosecutors will still have to satisfy this "property" requirement to obtain a conviction under § 1348. In *Blaszczak*, for example, the court found that CMS's confidential information was "property" because CMS had a proprietary right to exclude the public from such information. To successfully prosecute the conduct at issue in *Dirks* under Title 18, the government would similarly have to convince a court that a financial firm has a property interest in maintaining the secrecy of its own fraudulent practices.

Conclusion

Blaszczak is a significant decision that could allow the government to more expansively prosecute insider-trading cases without regard to the issue of "personal benefit." *Blaszczak* essentially allows prosecutors to avoid the Supreme Court's ruling in *Dirks* so long as they can show a defendant defrauded a victim of "property." Whether prosecutors find Title 18's "property" requirement more inviting than Title 15's "personal benefit" test remains to be seen.

Matthew D. Feil *is a partner in the New York office of BakerHostetler's Litigation Team.* **Andrew M. Serrao** *is an Associate in the New York office of BakerHostetler's White Collar, Investigations and Securities Enforcement and Litigation Team. The views expressed in this article are those of the authors and not necessarily those of BakerHostetler or its clients.*

10.02.20.15.44_p04