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Second Circuit Holds that a "Personal Benefit" Is Not Required for Insider Trading Under Criminal Securities Statute

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The Second Circuit held earlier this week that the criminal statute proscribing securities fraud permits convictions for insider trading without proof that the provider of material, nonpublic information received a personal benefit in exchange for that information, even though proof of a personal benefit would be required under the general securities-law statute prohibiting insider trading. The decision in *United States v. Blaszczak* could ease prosecutors' burden in obtaining convictions for insider trading by enabling the government to avoid the potentially complicated "personal benefit" issue, which has generated much litigation in recent years. The ruling would not affect civil cases, to which the criminal statute does not apply.The court also held that a government agency's confidential information can constitute "property" or a "thing of value" for purposes of prosecutions under the criminal securities-fraud, wire-fraud, and conversion statutes.

Background

Insider-trading cases, whether civil or criminal, have traditionally been brought under the general securities-law statute prohibiting securities fraud, 15 U.S.C. § 10(b) ("Title 15"). The Supreme Court held many years ago that an insider cannot be convicted of Title 15 securities fraud unless the government proves that he or she breached a duty of trust or confidence by using or disclosing material, nonpublic information ("MNPI") in exchange for a "personal benefit." *Dirks v. SEC*. Similarly, courts have generally agreed that a tippee cannot be convicted of securities fraud unless he or she used or conveyed the MNPI knowing that it had been obtained in breach of the insider's duty (a standard that includes the tippee's knowledge of the tipper's receipt of a personal benefit).

In 2014, the Second Circuit sought to tighten the personal-benefit requirement. That decision triggered a round of reactions by the Ninth Circuit, the Supreme Court, and, eventually, the Second Circuit itself, which largely retreated from its own 2014 decision.

In the meantime, some prosecutors appear to have decided to try to avoid the doctrinal confusion involving Title 15 securities fraud by prosecuting insider trading under a specific criminal statute – 18 U.S.C. § 1348 – instead of (or in addition to) under Title 15's general anti-fraud provision. Prosecutors have argued that, whatever the personal-benefit test might be under Title 15, it does not apply under Title 18.

Section 1348 imposes criminal liability on anyone who "knowingly executes, or attempts to execute, a scheme or artifice" either (1) "to defraud any person in connection with" any commodity or any security of a registered issuer or (2) "to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of" any such commodity or security. The language is derived from the federal mail-fraud and wire-fraud statutes. Because § 1348 is a criminal statute, the SEC cannot use it for civil enforcement actions.

The Blaszczak Case

The Blaszczak case involved prosecutions of four individuals in connection with alleged schemes to obtain nonpublic information from the federal Centers for Medicare and Medicaid Services (the "CMS") about reimbursement rates for certain medical treatments. A CMS employee had allegedly given MNPI to a friend (Blaszczak), a former CMS employee who was then working as a consultant; the consultant then passed the information to persons at two hedge funds, who traded on it. The CMS employee allegedly had received benefits from the tippee-consultant in the form of free meals, tickets to sporting events, and an offer to join the consultant's firm.

The government charged all defendants with securities fraud under Title 15 and also with violations of § 1348 and the wire-fraud and conversion statutes. The court's jury instructions on the Title 15 charge addressed all the familiar elements – including whether the tipper (the CMS employee) had owed and breached any duty of trust or confidence to his agency, whether he had received a personal benefit for doing so, and whether the tippee defendants had known of the tipper's breach of duty and receipt of a benefit. The defendants asked the court to include those same elements in its charge under § 1348, but the court denied the request, requiring the jury to find only that the defendants had knowingly and willfully engaged in "an illegal scheme or artifice" by providing confidential CMS information "to another person for the purpose of buying or selling securities on the basis of that information." The charge did not say anything about the tipper's duty to the agency, his alleged receipt of a personal benefit, or the tippees' knowledge of either of those things.

The jury acquitted the defendants on the Title 15 securities-fraud charges, but convicted them of § 1348 violations (except the CMS employee, who was convicted of wire fraud and conversion of government property). The Second Circuit, in a 2-1 decision, affirmed the convictions.

Second Circuit's Decision

The Second Circuit held that the personal-benefit test required for Title 15 securities fraud does not apply to Title 18 securities fraud under § 1348 (or to wire fraud under 18 U.S.C. § 1343).

The court began by observing that the Title 15 and Title 18 fraud statutes have certain common features: both prohibit schemes to "defraud"; both construe "defrauding" to include embezzlement or misappropriation of confidential information; and neither mentions a "personal benefit" test in the statutory text. But the two statutes differ as to a personal-benefit requirement because Title 15 securities fraud "depends entirely on the purpose of the [Securities] Exchange Act," while Title 18 securities fraud derives from the embezzlement theory of fraud.

The court explained that “the personal-benefit test is a judge-made doctrine premised on the Exchange Act’s statutory purpose,” which is “to protect the free flow of information into the securities markets” while “eliminat[ing] [the] use of inside information for personal advantage.” Securities fraud under Title 18, in contrast is “derived from the law of theft or embezzlement,” where a breach of duty (including receipt of a personal benefit) is not an additional prerequisite. “In the context of embezzlement, there is no additional requirement that an insider breach a duty to the owner of the property, since it is impossible for a person to embezzle the money of another without committing a fraud upon him. Because a breach of duty is thus inherent in . . . embezzlement, there is likewise no additional requirement that the government prove a breach of duty in a specific manner, let alone through evidence that an insider tipped confidential information in exchange for a personal benefit.”

The court was not moved by the defendants’ argument that eliminating the personal-benefit requirement from Title 18 securities fraud (and wire fraud) would give the government “a different – and broader – enforcement mechanism to address securities fraud than what had previously been provided in the Title 15 fraud provisions.” Rather, the court concluded that § 1348 was designed to achieve that result.

The court also held that, “in general, confidential government information may constitute government ‘property’ for purposes of” the Title 18 securities-fraud and wire-fraud statutes. “[G]overnment agencies have strong interests – both regulatory and economic – in controlling whether, when, and how to disclose confidential information relating to their contemplated rules” (here, CMS’s rules about reimbursement rates). In addition, the court upheld the convictions under the statute prohibiting conversion of federal property (18 U.S.C. § 641), ruling that the government’s confidential information constituted a “thing of value.”

Judge Kearse dissented because she did not consider the agency’s predecisional regulatory information to be “property” or a “thing of value” under Title 18.

Implications

The government's ability to use Title 18 to avoid Title 15's breach-of-duty and personal-benefit requirements could facilitate insider-trading prosecutions where the government cannot prove (or does not want to undertake the burden of proving) that the insider received a personal benefit in exchange for providing MNPI – or that remote tippees knew about any such benefit. Title 18 will not affect SEC civil proceedings, but the government has been using § 1348 more frequently in recent years, and the Blaszczak decision is likely to fuel that trend.

From a compliance point of view, the existence of this alternative prosecutorial route under § 1348 emphasizes the importance of making compliance judgments based on avoiding prosecution, rather than on framing defenses. If trading decisions do not involve MNPI, the relatively lower prosecutorial burdens under § 1348 should not be cause for concern.

Focusing on whether MNPI is at issue – rather than on whether a breach of duty occurred or a legally sufficient personal benefit existed – also avoids potential liability under the European Union's Market Abuse Regulation (the "MAR"), which is more stringent than traditional U.S. insider-trading law. The MAR prohibits use of material information that the user knows or should have known is nonpublic. Issues of the existence and breach of a duty and the receipt of a personal benefit are irrelevant. The MAR thus promotes a parity-of-information regime that the U.S. securities laws have not adopted. The MAR applies to all securities admitted for trading on an EU market, even if they are cross-listed in the United States, and even if the trading at issue occurs only on a U.S. market. Thus a U.S. trader who purchases on a U.S. market a security that is also admitted for trading on an EU market might theoretically be subject to the MAR's requirements.

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