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Second Circuit Questions Use of Criminal Insider-Trading Statute Without Proof of Receipt of Personal Benefit

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The Second Circuit held yesterday that a government agency's nonpublic, pre-decisional regulatory information does not constitute "property" for purposes of the federal insider-trading and wire-fraud statutes. The decision in *United States v. Blaszczak* (2d Cir. Dec. 27, 2022) ("*Blaszczak II*") effectively vacated convictions under those statutes for defendants who had traded on nonpublic, market-moving information that had been obtained from a government agency.

In a separate "concurrence" having potentially broader legal ramifications, two members of the panel also expressed concerns (in *dicta*) about the government's use of the criminal insider-trading statute to prosecute tipper-tippee insider trading without needing to prove that the tipper received a "personal benefit," as required under the federal securities laws.

The majority's ruling on the use of nonpublic governmental information under insider-trading and wire-fraud statutes will likely not affect most insider-trading cases, which generally involve material nonpublic information ("MNPI") obtained from nongovernmental sources. But the views expressed in the concurrence, if ultimately adopted by the courts or Congress, could shut down an approach that the government has been using to avoid the potentially complicated "personal benefit" issue, which has generated much litigation in recent years.

Background

Blaszczak II marked the case’s second appearance in the Second Circuit. When court issued its first decision in *Blaszczak I* in December 2019, most of the attention had focused on the court’s upholding the government’s use of the criminal statute prohibiting insider trading (18 U.S.C. § 1348) as a way to avoid having to prove that the provider of MNPI had received a personal benefit in exchange for that information or that a tippee had known of the tipper’s receipt of a personal benefit.

Insider-trading cases have traditionally been brought under the general securities-law statute prohibiting securities fraud, 15 U.S.C. § 10(b) (“Title 15”). An insider or other tipper cannot be held liable for securities fraud under Title 15 unless he or she breached a duty of trust or confidence by using or disclosing MNPI in exchange for a personal benefit. Similarly, a tippee cannot be held liable for Title 15 securities fraud unless he or she used or conveyed the MNPI knowing that it had been obtained in breach of the tipper’s duty (a standard that includes the tippee’s knowledge of the tipper’s receipt of a personal benefit).

Because the personal-benefit requirement sometimes creates potential difficulties of proof, some prosecutors began to prosecute insider trading under 18 U.S.C. § 1348, which (according to those prosecutors) does not require proof of a personal benefit. 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.

The *Blaszczak* Case

Blaszczak 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; Blaszczak then passed the information to persons at two hedge funds, who traded on it. The CMS employee allegedly had received benefits from Blaszczak in the form of free meals, tickets to sporting events, and an offer to join Blaszczak’s firm.

The government charged all defendants with traditional 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 the standard 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 of Title 15 securities fraud, but convicted them of some combination of violating § 1348 and/or the wire-fraud and conversion statutes.

Second Circuit's Initial Decision (*Blaszczak I*)

The Second Circuit, in a 2-1 decision by Judge Sullivan, affirmed the convictions, holding 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 rejected 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." 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 pre-decisional regulatory information to be "property" or a "thing of value" under Title 18.

The Supreme Court's *Kelly* Decision and Its Aftermath

While *Blaszczak* was working its way through the courts, a separate prosecution arising from the "Bridgegate" scandal was also proceeding. Bridgegate involved alleged political retaliation by the Governor of New Jersey's Deputy Chief of Staff and the Deputy Executive Director of the Port Authority of New York and New Jersey (whom the Governor had appointed) against a local mayor who allegedly had thwarted the Governor's wishes.

According to the government's allegations, the Governor – a Republican – was up for reelection and wanted to win a large bipartisan victory to promote his presidential aspirations. The Deputy Chief of Staff sought endorsements from Democratic mayors, including the Mayor of Fort Lee, but the Mayor declined to endorse the Governor. Supposedly in retaliation for the Mayor's refusal to cooperate, the Deputy Chief of Staff worked with the Port Authority's Deputy Executive Director and others to fabricate a "traffic study" that involved closing critical Fort Lee access lanes on the George Washington Bridge, thereby causing traffic to back up and create chaos in Fort Lee.

The government prosecuted the Deputy Chief of Staff and the Port Authority's Deputy Executive Director on charges of wire fraud, fraud on a federally funded program or entity (the Port Authority), and conspiracy to commit those two crimes. The jury found the defendants guilty on all counts, and the Court of Appeals for the Third Circuit affirmed.

The Supreme Court unanimously reversed the convictions in May 2020. The Court held that the statutes at issue prohibited deceptive conduct to deprive the victim of "money or property," so the government needed to prove not only that the defendants had engaged in deception, but also that *property* had been an object of their deception. The realignment of the bridge's traffic lanes, however, was "a quintessential exercise of regulatory power," rather than an appropriation of the Port Authority's property. And although the scheme had required the use of a public employee's paid time (which could be considered governmental property), the defendants "never had that as an object." "The use of Port Authority employees was incidental to – the mere cost of implementing – the sought-after regulation of the Bridge's toll lanes," rather than an effort to deprive the government of its property.

Kelly revitalized the issue that the *Blaszczak* defendants had raised and on which Judge Kearse had based her dissent: whether CMS's confidential, pre-decisional regulatory information was "property" under 18 U.S.C. § 1348 and the wire-fraud statute. Accordingly, the Supreme Court vacated and remanded the *Blaszczak* convictions for reconsideration in light of *Kelly*.

In briefing on remand, the government agreed with the defendants' argument that the convictions could not stand under *Kelly*. The government's brief stated that the Department of Justice "now" takes the position 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 purposes of 18 U.S.C. §§ 1343 and 1348" and that CMS's "confidential information at issue in this case does not constitute 'property' or a 'thing of value' under the relevant statutes after *Kelly*."

Second Circuit's Decision on Remand (*Blaszczak II)*

The Second Circuit, in a 2-1 decision written by Judge Kearse (who had dissented in *Blaszczak I*), held that *Kelly* and “the prosecutorial discretion to which the Executive Branch is entitled” required remanding the Title 18 securities-fraud, wire-fraud, and conversion convictions to the District Court for dismissal. The majority spent many pages explaining the “broad discretion” that rests with the government to prosecute or not prosecute under federal criminal statutes, but it acknowledged that the judiciary ultimately must decide whether to accept the government’s confession of error. The majority concluded that, in light of *Kelly*, the relevant statutes did not apply to the conduct at issue.

The majority stressed that federal fraud statutes such as § 1348 and the wire-fraud statute “are limited in scope to the protection of property rights,” so the government must prove that “the object of the defendants’ fraudulent scheme was money or property.” Those statutes prohibit “only deceptive schemes to deprive [*the victim*] of money or property.” Inasmuch as CMS was the purported victim of its employee’s leak, “defendants could not properly be convicted of violating §§ 1343, 1348, or 641 unless the objective of their schemes and conduct was the money or property of CMS.”

The majority held that CMS’s confidential, pre-decisional regulatory information was not CMS’s “property” here because “CMS is not a commercial entity; it does not sell, or offer for sale, a service or a product.” Moreover, the planned regulation, even if prematurely disclosed to outsiders, remained “within the exclusive control of CMS”; its disclosure thus had “no direct impact on the government’s fisc,” even if the leak “might well impact CMS’s subsequent regulatory choices.” The court therefore ruled that “merely obtaining advance information as to what the agency’s preferred regulation would be, and when it would be announced, cannot properly be considered the agency’s money or property or a thing of value that could be ‘convert[ed].’”

The overturning of the convictions underlying *Blaszczak I* led Judge Walker (joined by Judge Kearse) to write a separate "concurrence" to discuss the fate of another part of the holding of that case: that criminal liability for tipper-tippee insider trading under § 1348 does not require proof that the tipper received a personal benefit, even though criminal and civil liability for Title 15 securities fraud would require such proof. That difference struck Judges Walker and Kearse as "odd" because "traditional notions of fair play are offended by the present incongruence in this circuit between civil and criminal deterrence." "It should not require fewer elements to prove a criminal conviction than to impose civil penalties for the same conduct. This asymmetry deserves the further attention of our court, the Supreme Court, and Congress."

According to Judges Walker and Kearse, the personal-benefit test for Title 15 securities fraud "creates at least some legal distinction between those who gave and obtained tips fraudulently and those who appropriately engaged in the honest disclosure and collection of corporate information." Without that limiting principle, "corporate insiders may be more reticent to share information with analysts in the ordinary course of business and analysts who do receive company information may be less likely to act on it for fear of running afoul of § 1348."

Judge Sullivan, who had written the majority decision in *Blaszczak I*, dissented on both points. First, he did not read *Kelly* as altering the conclusion that nonpublic CMS information was "property" for purposes of § 1348 and the wire-fraud statute. Second, he objected to the concurrence's "gratuitous advisory opinion" on whether § 1348 requires a "personal benefit." Judge Sullivan opined that the personal-benefit test under Title 15 "is a judge-made rule premised on the statutory purpose of the Securities Exchange Act," and he saw "no obvious reason to extend that rule to a different statutory provision under Title 18." He also observed that § 1348 had been enacted in the wake of the 2008 financial crisis to provide new criminal and civil tools to federal investigators and prosecutors, so "[t]he history and purpose of section 1348 therefore make it far more plausible that Congress did not intend for it to be a mere carbon copy of the Title 15 securities-fraud statute."

Implications

Blaszczak II raises a number of considerations for insider-trading claims in the future.

First, and perhaps foremost, the concurrence could lead the Second Circuit, other courts, or Congress to reevaluate whether the government can use Title 18 to avoid Title 15's breach-of-duty and personal-benefit requirements. Title 18 appears to have facilitated insider-trading prosecutions where the government could not prove (or did not want to undertake the burden of proving) that the insider had received a personal benefit in exchange for providing MNPI – or that remote tippees had known about any such benefit. *Blaszczak* itself illustrates the difference that the availability of a Title 18 count can make: the jury acquitted the defendants of Title 15 securities fraud even though it convicted them under Title 18. Several other courts have relied on *Blaszczak I*'s ruling to uphold Title 18 counts, but that ruling has now been questioned.

Second, the holding that a government agency's confidential regulatory information is not its "property" for purposes of Title 18 securities fraud and wire fraud could prevent prosecutions for insider trading under those statutes. But the decision does not address whether use of or tips about such information could give rise to civil or criminal liability under Title 15. Moreover, any such misuse of confidential governmental information might now fall within the terms of the STOCK Act (the "Stop Trading on Congressional Knowledge Act"), which Congress enacted in 2012 to clarify that the insider-trading laws apply to members of the legislative, executive, and judicial branches. The STOCK Act was not at issue in the *Blaszczak* decisions.

Third, in holding that CMS's confidential regulatory information was not CMS's "property" under Title 18, the court contrasted CMS with a commercial entity, for which confidential information might be "its stock in trade, to be gathered at the cost of enterprise, organization, skill, labor, and money, and to be distributed and sold to those who [would] pay money for it." The court's ruling as to CMS thus would not seem to apply where, for example, an employee of a newspaper misappropriates his or her employer's confidential pre-publication information for trading or tipping purposes (as the Supreme Court held several decades ago). A similar issue has recently arisen in a wire-fraud prosecution of an employee of an NFT marketplace who traded digital assets based on his knowledge of the NFTs that his employer planned to feature on its home page.

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