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Expert Q&A on Insider Trading Law After *United States v. Blaszczak*

The Second Circuit recently held in *United States v. Blaszczak* that criminal fraud actions for insider trading under Title 18 of the US Code do not require proof that a provider of material nonpublic information received a personal benefit in exchange for that information. This decision has the potential to significantly lessen the burden on prosecutors in tipper-tippee insider trading cases. Practical Law asked *Jonathan Haray* of *DLA Piper LLP (US)* to explain how the *Blaszczak* ruling may change the landscape for insider trading litigation and to highlight other developments in insider trading law.

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What is the factual and procedural background of *Blaszczak*?

In *United States v. Blaszczak*, the Second Circuit considered a challenge to the convictions of four individuals charged with wire fraud, securities fraud and conspiracy, and conversion of US property under Title 18 of the US Code (18 U.S.C. §§ 1343, 1348, and 641, respectively) and securities fraud under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) (15 U.S.C. § 78j) on grounds that they misappropriated confidential nonpublic information from the Centers for Medicare & Medicaid Services (CMS). The indictment alleged that a CMS employee disclosed the agency's confidential information to a political intelligence consultant for hedge funds, who in turn passed on the information to two hedge fund employees who traded on the information. (947 F.3d 19, 26 (2d Cir. 2019).)

The case proceeded to a jury trial and the district court, based on the US Supreme Court's 1983 decision in *Dirks v. SEC* (463 U.S. 646 (1983)), instructed the jury that to convict the defendants on the Section 10(b) charge, it must find that the CMS employee disclosed the confidential information in exchange for a "personal benefit" and that the other defendants knew that the information was disclosed in exchange for a personal benefit. However, the district court refused to give the personal benefit instruction on the Title 18 charges. (*Blaszczak*, 947 F.3d at 29.)

The jury acquitted the defendants on the Section 10(b) charge, but found them guilty of the Title 18 wire fraud and conversion of US property charges. Additionally, it found all of the defendants except the CMS employee guilty of the Title 18 securities fraud and conspiracy charges. The defendants appealed. (*Blaszczak*, 947 F.3d at 29-30.)

How do Title 18 wire fraud and securities fraud claims differ from Title 15 claims, including securities fraud claims under Section 10(b) and its implementing regulation, Rule 10b-5?

Title 18 offenses are solely criminal. Therefore, the government must prove the elements of a Title 18 fraud claim beyond a reasonable doubt. More specifically, to establish a Title 18 wire fraud claim, the government must prove beyond a reasonable doubt that:

- The defendant engaged in a scheme to defraud to obtain money or property by means of false representations, statements, or promises.
- The defendant had the intent to defraud.
- An interstate wire transmission was made in furtherance of the scheme.

(18 U.S.C. § 1343.)

The elements of securities fraud under Title 18 are similar to wire fraud, but rather than an interstate wire transmission, securities fraud requires a connection to the sale or purchase of a security or commodity (18 U.S.C. § 1348).

Search Mail and Wire Fraud Under 18 U.S.C. §§ 1341, 1343, and 1346 for more on the Title 18 wire fraud offense.

Unlike Title 18, the Exchange Act provides for both civil and criminal penalties for a violation of Section 10(b), and the elements of a civil claim must be shown by a preponderance of the evidence. While Section 10(b) is a general anti-fraud statute used to pursue various types of securities fraud cases, courts have over time developed the legal elements for proving an insider trading claim under Section 10(b) and Rule 10b-5. However, establishing these elements can be challenging as courts interpret and reinterpret precedent to shape the legal contours of Section 10(b) insider trading claims and apply this precedent to new factual scenarios that emerge.

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Moreover, the jury instructions in a Section 10(b) insider trading case can be fairly lengthy and complicated, which can present challenges for Securities and Exchange Commission (SEC) enforcement attorneys and federal prosecutors trying these cases in court. The more complex the jury instructions, the more issues that a defense counsel can raise to argue that their client should be found not liable.

What were the underlying issues in *Blaszczak* on appeal?

On appeal, the Second Circuit, among other things, addressed for the first time whether the personal benefit test for Section 10(b) tipper-tippee insider trading claims applies to wire fraud and securities fraud charges under Title 18. The personal benefit test, established by the Supreme Court in *Dirks*, requires courts to consider whether a corporate insider (the tipper) personally benefitted, directly or indirectly, from a disclosure of confidential information to a third party (the tippee) who trades based on that information (463 U.S. at 659-60). Tippees can become tippers by passing information along to others later in the chain of events. *Dirks* held that, without a personal benefit, or knowledge of that benefit by the tippee or other more remote, downstream tippees, no liability exists under Section 10(b).

The personal benefit element of tipper-tippee liability has been the subject of intense focus in recent years and has generated great uncertainty among litigants, with courts narrowing and ultimately expanding what constitutes a personal benefit. In *Salman v. United States*, the Supreme Court addressed the extent to which an inference of a personal benefit can be drawn in the absence of evidence of direct financial gain. Relying on *Dirks*, the Court held that a personal benefit includes the benefit an insider would obtain from making a gift of confidential information to a trading relative or friend. The Court explained that making a gift of inside information to a relative or friend is similar to personally trading on the information and gifting the profits to the relative or friend. The insider benefits in either scenario. Therefore, when a tipper gives inside information to a trading relative or friend, a jury can infer that the tipper meant to provide the cash equivalent of a gift. (*Salman*, 137 S. Ct. 420, 428 (2016).)

In *Blaszczak*, the Second Circuit considered whether the district court erred by failing to instruct the jury on the *Dirks* personal benefit test with respect to the Title 18 wire fraud and securities fraud charges (947 F.3d at 30).

Search Defending Against Insider Trading Claims for more on the elements of an insider trading claim, including the personal benefit requirement.

What was the Second Circuit's ruling in *Blaszczak*, and why is it significant?

Although *Blaszczak* involved several interesting issues, its impact on insider trading law has justifiably received the most attention. The Second Circuit held that the personal benefit requirement of a tipper-tippee insider trading claim under Section 10(b) does not apply in criminal cases charged under Title 18 of the US Code, including wire fraud and securities fraud charges. Therefore, the Second Circuit concluded that the district court did not err in refusing to instruct the jury on the personal benefit test for the Title 18 offenses and upheld the jury's verdict. (*Blaszczak*, 947 F.3d at 35-37, 45.)

In agreeing with the government that the personal benefit element does not extend beyond a Section 10(b) action, the Second Circuit explained that the personal benefit test is grounded in Congress's purpose in enacting the fraud provisions of the Exchange Act, which included eliminating the "use of inside information for personal advantage." However, that legislative intent does not guide the Title 18 wire fraud and securities fraud statutes. The court noted that the Title 18 securities fraud statute, enacted as part of the Sarbanes-Oxley Act of 2002, was expressly drafted to broaden the enforcement tools available to prosecutors and have greater reach than the Title 15 securities laws. Given these different legislative goals, the court found no basis for applying Section 10(b)'s personal benefit test to a Title 18 fraud offense. (*Blaszczak*, 947 F.3d at 35-36.)

The *Blaszczak* ruling, which represents a substantial departure from traditional insider trading law, unleashes federal prosecutors to pursue insider trading charges in a broader range of cases than the SEC could bring under the federal securities laws. This stands to make it easier in some instances for prosecutors to convict defendants for insider trading under Title 18.

How might *Blaszczak* impact government decisions on how to pursue insider trading actions?

Given the hurdles federal prosecutors face in establishing claims under Section 10(b), following *Blaszczak*, they may abandon the pursuit of Title 15 charges when they can proceed under Title 18 (on the other hand, the SEC must continue to charge civil offenses under Section 10(b)). Although any criminal prosecution involves a higher burden of proof, having to prove fewer essential elements for a Title 18 fraud claim undoubtedly benefits prosecutors over defendants in cases involving Title 18 offenses. This was demonstrated by the jury verdict in *Blaszczak*, where the defendants who were convicted of insider trading under Title 18 were acquitted of insider trading under Section 10(b). That result speaks for itself.

Additionally, *Blaszczak* demonstrates the willingness of prosecutors to push boundaries and test new theories of liability to expand the reach of insider trading law. We should expect prosecutors to look for opportunities to use this ruling to create other advantages for themselves in Title 18 securities fraud cases and, where possible, avoid being bound by precedent applicable to Section 10(b) claims.

How do you expect counsel will proceed after *Blaszczak* when defending insider trading claims under Title 18?

Counsel involved in an SEC insider trading investigation will now have even greater cause for concern if the investigation turns criminal. Federal prosecutors (in the Second Circuit for now) no longer need to show a personal benefit in a tipper-tippee insider trading case, meaning they now have fewer essential elements to prove. Even though the personal benefit element was not exceedingly difficult to establish after the Supreme Court's ruling in *Salman*, in practice it served as a barrier to certain cases going forward or otherwise succeeding.

Nevertheless, the concept of a personal benefit is still relevant. Defense counsel will likely argue that the notion of a personal benefit remains embedded in the elements of wire fraud and securities fraud under Title 18, which require a showing of the defendant's intent to obtain money or property through fraudulent means. In *Blaszczak*, that requirement was established by the fact that the defendants had allegedly embezzled proprietary information that was ultimately passed along to others who traded on it. Without an underlying fraudulent act, however, prosecutors may face a more difficult hurdle in future cases.

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Have there been any efforts toward enacting insider trading legislation to help clarify the relevant standards?

The complex and often shifting body of case law addressing the essential elements of an insider trading claim under Section 10(b) has frequently been cited as a reason for enacting insider trading legislation. In December 2019, the US House of Representatives passed the Insider Trading Prohibition Act (ITPA) (H.R. 2534), which largely codifies the existing elements of insider trading law under Section 10(b). In some respects, the ITPA may broaden the current law by:

- Including information obtained by mere theft in its ban on the wrongful use of material nonpublic information when trading. Courts currently adopt different standards when imposing insider trading liability based on stolen information (see, for example, *SEC v. Dorozhko*, 574 F.3d 42, 51 (2d Cir. 2009) (finding that insider trading captures information obtained by cyber hacking if the specific hacking method is "deceptive")).
- Potentially expanding the scope of liability in tipper-tippee cases where the tipper communicated material nonpublic information and it was "reasonably foreseeable" that the tippee would trade on that information. More generally, the knowledge requirement of the ITPA raises questions about whether the legislation merely codifies current law on the requisite state of mind needed to prove an insider trading claim or lowers the threshold.
- Omitting any requirement to prove that a defendant or respondent used or employed a manipulative or deceptive device or contrivance, an essential component of a Section 10(b) securities fraud claim that the elements of an insider trading claim aim to establish.

The ITPA is currently subject to Senate approval. It is unclear when the Senate will vote on the ITPA and whether there will be any amendments to the bill. In any event, the ITPA will not eliminate all uncertainty related to the elements of insider trading. Like any other statutory provision, courts will still be called on to resolve questions about the ITPA's application to the facts of a given case.

Additionally, in January 2020, the House of Representatives took another step to prevent insider trading by passing the 8-K Trading Gap Act of 2019 (H.R. 4335). Under current SEC rules, public companies must file a Form 8-K to disclose certain material corporate events within four business days of the event, as opposed to waiting to report the information as part of a quarterly or an annual filing. With certain exceptions, the 8-K Trading Gap Act would require public companies to "establish and maintain policies, controls and procedures" designed to prohibit executive officers and directors from trading during the four-day "gap" period between the material event and its public disclosure through the filing of the Form 8-K. While many companies already have policies in place to prevent such trading, including by imposing "black out" periods that prohibit insiders from trading on material nonpublic information, this bill, if enacted, will provide more ammunition for the SEC to police possible insider trading. PL