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Second Circuit Confirms Easier Path to Insider Trading Convictions

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On December 30, 2019, the United States Court of Appeals for the Second Circuit affirmed four insider trading guilty verdicts and, in doing so, forged an easier path to securing insider trading convictions—particularly those against downstream tippees who may not personally know the source of the inside information.

Background

The government traditionally prosecutes insider trading under Section 10(b) of the Securities and Exchange Act, 15 U.S.C. § 78j(b), and SEC Rule 10b-5 ("Title 15"). But this statutory and regulatory anchor focuses merely on "manipulative," "deceptive," and "fraudulent" practices, and does not prohibit insider trading specifically. Judicial attempts to carve out a defined insider trading crime under Title 15 left a great deal of uncertainty over how and when liability attaches, especially when considering the recipient of material, non-public information (MNPI), the tippee, who trades on that information, but owes no duty—fiduciary or otherwise—to the source of that information. To criminalize tippee trading, the Supreme Court in *Dirks v. SEC* developed the "personal benefit" test, which was meant to bind the tippee and tipper, so much so that breach of the *tipper*'s fiduciary duty could be imputed to the tippee as well. This maneuver yielded a muddled test and an unclear standard, and has impacted the government's conviction rate, especially when charging "remote" tippees, who had little to no connection to the original source.

With the contours of the "personal benefit" test still unclear, prosecutors in recent years have increasingly turned to 18 U.S.C. § 1348 ("Title 18") as an alternative means to charging insider trading conduct. Prosecutors have argued that the "personal benefit" test, judicially-infused into Title 15 cases, has no place in the Title 18 offense, which focuses on the theft and misuse of confidential information. Last week, the Second Circuit agreed with this approach. In *United States v. Blaszczak*, the court held that the personal benefit test established in *Dirks* does not apply to the Title 18 fraud statutes.

***Blaszczak* and the Second Circuit's Decision**

In *Blaszczak*, the government charged four defendants with engaging in a scheme to convert confidential government property from the Centers for Medicare & Medicaid Services (CMS) and trade on it. For each of the trades, the government charged securities fraud under both Title 15 and Title 18 (as well as conversion of government property, wire fraud, and conspiracy). The tipper was acquitted of both the Title 15 and Title 18 insider trading charges. But on the same facts and trades, the jury convicted all three tippees of insider trading under Title 18, but *acquitted* them under Title 15. Notably, the Title 15 instructions took up *20* pages of transcript and included 10 specific issues for the jury to consider, including whether the tipper expected a personal benefit in exchange for information, and whether the tippees knew that. The Title 18 jury instruction, in contrast, occupied four pages of transcript only, and, despite the defense's request, omitted any reference to the "personal benefit" test.

The Second Circuit affirmed the trial court's decision to omit the "personal benefit" test from its Title 18 charge. The Court explained that although the Title 15 fraud statute and Title 18 fraud provisions both prohibit schemes to "defraud," which encompasses the so-called "embezzlement" or "misappropriation" theory of fraud, the personal benefit test is a judge-made doctrine designed to fulfil the Exchange Act's purpose: to eliminate the use of inside information for personal advantage. In contrast, the personal benefit test is not grounded in the embezzlement theory of fraud, which Title 18 was designed to address. Thus, Title 18 fraud requires neither a breach of fiduciary duty nor receipt of a personal benefit. Indeed, Title 18 was "intended to provide prosecutors with a different—and broader—enforcement mechanism to address securities fraud than what had been previously provided in the Title 15 fraud provisions."

Implications/Conclusion

Blaszczak marks the first time an appellate court opined on whether the government can criminally prosecute insider trading under Title 18 without proving receipt of a personal benefit by the tipper, or knowledge of the tipper's personal benefit by the tippee. With the Second Circuit's approval, prosecutors are expected to continue to charge insider trading under both Title 15 and Title 18. Oddly, they will arguably have an easier path to criminal convictions than their SEC colleagues, still bound by the intricate Title 15 framework. As a result, individuals, including corporate and government insiders, and investment professionals, may face criminal, but not civil liability for the same exact conduct. While the defendants in *Blaszczak* raised this and other policy concerns, the Court reminded the parties that "Congress was certainly authorized to enact a broader securities fraud provision, and it is not the place of courts to check that decision on policy grounds." It appears unlikely, however, that Congress would reconsider or clarify its intentions by enacting a designated anti-insider trading statute. The *Blaszczak* defendants, in the meantime, are expected to petition the Second Circuit for a rehearing *en banc*.

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