

Federal Fraud Statutes – Not A Short Cut to Proving Insider Trading

The question of what constitutes insider trading has been litigated for decades. Many thought that a series of Supreme Court cases such as *Dirks v. SEC*, 462 U.S. 646 (1983) and its progeny had largely resolved the question about the basic elements of the unlawful conduct. *Blaszczak v. U.S.*, 947 F.3d 19 (2nd Cir. 2019) however, an action prosecuted under the federal wire fraud statute and an fraud statute created as part of the Sarbanes-Oxley Act (“SOX”), suggested that perhaps proof of elements like the “personal benefits” test can be bypassed – a shortcut to insider trading liability.

Perhaps, but perhaps not. In a January 11, 2021 order the Supreme Court granted a Petition for a Writ of Certiorari in *Blaszczak v. U.S.*, No. 20-5649 and remanded the action for consideration in view of the decision in *Kelly v. U.S.*, No. 18-1059 (May 7, 2020). Jury found him guilty on charges which included the wire fraud statute and the SOX fraud statute. While the Defendants had also been charged with violations of Exchange Act Section 10(b), all of those charges had either been dismissed or rejected by the jury.

Second Circuit decision – inside information is property

David Blaszcak, a political intelligence consultant employed by a hedge fund, was convicted by a jury based on a scheme which appeared to be insider trading. The charges trace to inside information transmitted by Christopher Wordell, an employee at Centers for Medicare and Medicaid Services (“CMS”) or to his former co-worker, Defendant Blaszcak. The agency issues proposed and final rules that set the Medicare reimbursement rates. The releases often impact the share price of firms that offer products and services covered by the impacted fee changes. Accordingly, the rate changes are made after the close of the market.

Mr. Worrall had access to material non-public CMS decisions concerning reimbursement amounts under the applicable regulations. As a CMS employee he was subject to Section 21A(h) of the Exchange Act which imposes a duty of trust and confidence on

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executive branch employees to the U.S. Government and citizens of the United States with respect to material, non-public information. CMS, in addition, has an Employee Nondisclosure Policy that imposes similar duties regarding “market sensitive” information. The Standards of Ethical Conduct for Employees of the Executive Branch fortified those duties.

Despite his obligations, in three instances over a period of about one and one-half years, Mr. Worrall furnished inside information on CMS rate changes that lowered reimbursement rates to his long-time friend, Defendant Blaszcak. The information on each occasion was transmitted in personal meetings, on the telephone, in emails and through text messages. In each instance the information was conveyed by Mr. Blaszcak to Deerfield Management Company, LP, a healthcare-focused hedge fund with which he was affiliated. The Management Company traded securities on behalf of certain funds while in possession of the material, non-public information. The trading resulted in over \$3.9 million in illicit trading profits. A jury found Mr. Blaszcak guilty under each statute.

On appeal Mr. Blaszcak argued that the CMS information at the center of the trading scheme was not “property” within the meaning of the charging statutes, citing *Cleveland v. U.S.*, 531 U.S. 12 (2000). The Circuit Court rejected this contention.

The Circuit Court began its analysis by noting that the word “property” in each statute has the same meaning. *Cleveland*, which considered the property question, involved licenses to operate video poker machines. The licenses were found not to be property within the meaning of the statutes. The conclusion was based on the fact that the licenses had no economic value until issued. Similarly, the state’s right to control issuance of a license was not property within the meaning of the statute. To the contrary, it implicated only its role as a sovereign. While the decision was “good law,” according to the Circuit Court, it has been read narrowly by most courts.

In contrast, the CMS rights here are property rights, the Court found. The agency has what the Court called a “right to exclude” that is “comparable to” a property right. CMS has a “property right in keeping confidential and making exclusive use of its nonpublic pre-decisional information” (quotes and citations omitted). This view is consistent with the High Court’s ruling in *Cleveland* and those of other circuits construing that case. The point is bolstered by evidence submitted by CMS that it has an economic interest in the information. The convictions were affirmed. *U.S. v. Blaszcak*, 947 F. 3d 19, (2nd Cir. 2019).

Kelly and the petition for certiorari

Kelly, cited by the Supreme Court in its ruling, is the “Bridgegate” case. It arose from the closure of certain traffic lanes to the George Washington Bridge, a gateway to Manhattan from New Jersey, for political purposes. Charges were brought against the officials involved under two federal fraud statutes, Section 1343 and Section 666(a)(1)(A) of Title 18. Those statutes target, respectively, wire fraud and fraud on a federally funded program or entity.

Each fraud statute is grounded on property rights, Justice Kagan wrote for a unanimous Court. There was no doubt that the evidence demonstrated wrong doing such as deception, corruption and abuse of power, the Court noted. The realignment of the traffic lanes at issue in the case focused on an exercise of regulatory power, however, not the taking of a property right. Since the statutes on which the charges were based only involve property rights and “do not proscribe schemes to defraud citizens of their intangible rights . . .” there was no violation. The convictions were thus reversed.

In his Petition For a Writ of Certiorari the issue presented by Mr. Blaszcak is: “Whether information about a proposed government regulation is “property” and a “thing of value” belonging to the regulatory agency such that its disclosure can constitute the federal crimes of fraud or conversion.” The Supreme Court granted the petition, reversed the convictions, and remanded to the Second Circuit for further consideration.

Discussion

The Court’s order granting the petition and citing *Kelly* leaves little doubt that neither the wire fraud statute nor the SOX fraud statute were violated by the insider trading scheme at the center of the case. As in *Kelly*, there is no doubt that the conduct of a CMS employee tipping his friend with material nonpublic information to trade in the securities markets is wrongful. That does not mean it constitutes a violation of the wire fraud and SOX fraud statute under the decisions in *Cleveland* and *Kelly*. Property rights, as defined in those decisions, simply are not implicated.

The teachings of Blaszcak seem clear - prosecutors who want to charge insider trading should rely on Exchange Act Section 10(b) as the SEC did in filing parallel charges against Mr. Blaszcak. Other general fraud statutes should not be used as a kind of back-stop for Section 10(b) in case the proof fails to establish the elements of an insider trading claim. Stated differently – there are no shortcuts to proving insider trading.