Securities Regulation Daily Wrap Up, TOP STORY—2d Cir.: Dirks personal benefit not required in some insider trading prosecutions, (Jan. 6, 2020)

Securities Regulation Daily Wrap Up

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By Anne Sherry, J.D.

The government can avoid proving a personal benefit when it prosecutes insider trading under the criminal code, a Second Circuit panel held.

Affirming convictions for insider trading, the Second Circuit held that the *Dirks* personal-benefit test does not apply in criminal prosecutions under the wire fraud and securities fraud provisions of Title 18 of the U.S. Code. The court also held that confidential government information may constitute "property" for purposes of the same statutes. Dissenting, one judge disagreed with the holding that predecisional information allegedly misappropriated from the Centers for Medicare & Medicaid Services constituted property of the agency or the government (*U.S. v. Blaszczak*, December 30, 2019, Sullivan, R.).

One of the defendants had worked at the Centers for Medicare & Medicaid Services (CMS) before becoming a consultant to hedge funds. His former CMS colleagues disclosed confidential information to him, and he in turn tipped the other defendants, who worked for Deerfield Management Company, L.P. The Deerfield defendants traded on the information. For instance, in July 2009, the Deerfield partners shorted stock in a radiation-device manufacturer based on a tip that CMS would soon reduce the reimbursement rate for certain radiation oncology treatments. The tipper also provided CMS information to a hedge fund manager at Visium Asset Management, L.P. The insider trading continued through 2013.

An 18-count indictment in 2018 charged the defendants with violating Exchange Act Section 10(b) and Rule 10b-5 ("Title 15 securities fraud") as well as with criminal wire fraud and securities fraud under the criminal code, Title 18. The district court instructed the jury that, per the Supreme Court's *Dirks* opinion, it must find a "personal benefit" to convict on the Title 15 securities fraud charges. However, the court refused to give *Dirks*-style instructions on the Title 18 counts. While the jury acquitted all defendants of the Title 15 charges, it returned convictions on the wire fraud and Title 18 securities fraud charges. The defendants challenged these convictions on the bases (among others) that the tipped information was not "property" in the hands of CMS for purposes of the wire fraud and Title 18 securities fraud statutes and that the district court erred by not including a *Dirks* instruction as to the Title 18 fraud counts.

Property. In determining that the CMS information was "property," the court relied heavily on *Carpenter v. U.S.* (U.S. 1987) and *Cleveland v. U.S.* (U.S. 2000). In *Carpenter*, the Supreme Court held that the publication schedule and contents of forthcoming *Wall Street Journal* articles were the newspaper's property because it "had a property right in keeping confidential and making exclusive use" of the information prior to publication. In *Cleveland*, the Court held that the mail fraud statute did not reach fraud in obtaining a license to operate gaming machines because the licenses had no economic value until issued and the state's right to control the issuance of licenses implicated its role as sovereign, not as property holder. While *Cleveland* remains good law, courts have rejected attempts to expand its holding, the Second Circuit noted.

Like the *Wall Street Journal*, CMS had a property right in keeping confidential and making exclusive use of its nonpublic predecisional information. Its right to exclude the public from accessing that information implicated its role as property holder, not as sovereign. And while the Second Circuit did not read *Cleveland* to require the government's interest to be economic in nature, the government did present evidence of an economic interest in the predecisional information. For example, CMS resources into generating and maintaining the confidentiality of that information are devalued when the information is leaked. And leaks can hamper the agency's decision-

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making process, a risk that implicates not only CMS's regulatory interests but also its economic interest in allocating its resources efficiently.

The panel majority also rejected the defendants' argument that the CMS information was not property because there was no evidence that the agency suffered actual monetary loss. The Second Circuit distinguished the case from which the defendants cited a single sentence and found that a rigid monetary-loss requirement would be at odds with *Carpenter*. The *Carpenter* Court rejected such a requirement, finding it sufficient that the *Wall Street Journal* had been deprived of its exclusive use of the information because "exclusivity is an important aspect of confidential business information and most private property." Exclusivity is just as important in the context of confidential government information, the Second Circuit majority reasoned.

The dissenting judge disagreed with that analysis and would reverse the convictions that were based on substantive grounds and on conspiracy to commit the underlying offense. CMS is not a business, she wrote, and information is not its "stock in trade," unlike the newspaper in *Carpenter*. CMS also adopts its preferred planned regulation regardless of leaks. The judge does not view predecisional information as property subject to conversion or, similarly, as property within the meaning of the Title 18 securities and wire fraud statutes. "Given that CMS, notwithstanding any premature disclosure of its predecisional regulatory information, can issue a regulation that adheres to its preliminary inclination or can issue a different regulation, I cannot see that CMS has been deprived of anything that could be considered property." Indeed, like the gaming licenses in *Cleveland*, the predecisional information has no economic impact on the government until after CMS has decided what regulation to issue and when it will take effect, the dissent argued.

Reining in *Dirks*. The other significant holding of the case is that the personal-benefit test established in *Dirks v. SEC* (U.S. 1983) does not apply to the wire fraud and Title 18 securities fraud statutes. Both the Title 15 and Title 18 fraud statutes prohibit schemes to "defraud," encompassing theories of fraud based in embezzlement or misappropriation. However, the court reads *Dirks* as establishing the personal-benefit test based on the statutory purpose of the Exchange Act to protect the free flow of information into the securities markets. In requiring that an insider have tipped information in exchange for a personal benefit, *Dirks* explained that Congress enacted the Exchange Act fraud provisions with the "purpose of eliminating the use of inside information for personal advantage." This statutory context does not exist for Title 18.

Instead, in the context of embezzlement as formulated in *Carpenter*, there is no requirement that an insider have breached a duty to the property owner, since it is impossible to embezzle money without committing a fraud on the victim. And there is consequently no requirement that the insider have breached a duty in a specific manner, such as in exchange for a personal benefit. This conclusion applied to both the wire fraud and Title 18 securities fraud statutes, because while the latter concerns the securities laws, it does not share the statutory purpose underlying the Exchange Act. Sarbanes-Oxley added 18 U.S. §1348 to the criminal code largely to overcome the technical legal requirements of the Title 15 fraud provisions. Given that it was meant to provide prosecutors with a different, broader, enforcement mechanism, the court declined to extend *Dirks* to the Title 18 provision.

Finally, the court declined to extend *Dirks* on policy reasons. The defendants argued that if *Dirks* does not apply to Title 18, the government will avoid the personal-benefit test altogether by prosecuting insider trading under the more permissive statute. The appeals court declined to second-guess Congress's decision to enact a broader securities fraud provision, writing, "whatever the force of this argument as a policy matter, we may not rest our interpretation of the Title 18 fraud provisions on such enforcement policy considerations."

The case is No. 18-2811.

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