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Expert Analysis

Back to the Future: Criminal Insider Trading Under Title 18

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Section 10(b) of the Securities Exchange Act became law in 1934, and Rule 10b-5 was promulgated by the SEC in 1942, but it was not until the early 1960s, with *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), that the modern law of insider trading began to develop. Since that time, the government has brought insider trading charges based almost exclusively on violations of Rule 10b-5. However, the verdict in a recent insider trading prosecution in the Southern District of New York suggests that the primacy of Rule 10b-5 in criminal insider trading prosecutions may be reconsidered.

In *United States v. Blaszczak*, 17-Cr.-357-LAK (May 24, 2017), a grand jury returned an indictment charging insider trading based on unlawful tips about prospective changes to health care reimbursement rates. As to each instance of unlawful trading, the indictment charged criminal violations of both Section 10(b) and Rule 10b-5 (15 U.S.C. § 78j) and 18 U.S.C. § 1348—a fraud statute enacted as part of the Sarbanes-Oxley Act of 2002. The jury returned a verdict of not guilty on the four Rule 10b-5 charges under Title 15, and guilty on the four fraud charges under Title 18—even though the charges grew out of the very same transactions.

For each of the allegedly illegal trades, the government charged securities fraud under both Rule 10b-5 and 18 U.S.C. § 1348. (The government also charged conversion of government property, wire fraud and conspiracy.)

In this article, we begin with a discussion of the facts in *Blaszczak*, and then consider the jury instructions, which reflected stark differences in the elements of Title 15 and Title 18 violations. As a practical matter, the government was able to prove illegal insider trading under Title 18 without having to prove critical elements of illegal insider trading under Rule 10b-5. We then discuss how the Title 18 charges in *Blaszczak* hark back to the mail and wire fraud convictions for insider trading under 18 U.S.C. §§ 1341 and 1343 addressed in *Carpenter v. United States*, 484 U.S. 19 (1987). Lastly, we consider the implications when the elements of civil and criminal insider trading are significantly different.

'United States v. Blaszczak'

In *Blaszczak*, four individuals were charged with participating in two schemes to obtain material nonpublic information from the Centers for Medicare and Medicaid Services (CMS), and then use the information to trade stocks at hedge fund Deerfield Management Company, L.P. David Blaszczak, a consultant and former CMS employee, allegedly obtained confidential, nonpublic information concerning prospective changes to Medicare reimbursement rates for certain cancer and kidney treatments and then gave the information to Deerfield employees, whose subsequent trades netted the hedge fund over $7 million in profits.

Blaszczak obtained confidential information from Christopher Worrall, a personal friend who worked at CMS. The information concerned a planned CMS reimbursement cut for certain radiation oncology treatments two months prior to those cuts becoming public; and a proposed cut

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to CMS' kidney dialysis reimbursement rate before that cut was decided and announced. Blaszczak gave some of this information to codefendants Robert Olan and Theodore Huber, partners at Deerfield Management, and some to Jordan Fogel (a former Deerfield Management partner and witness for the government). Following receipt of the confidential information Deerfield shorted stocks that would be affected by the prospective cuts. In the course of providing information to Blaszczak, Worrall received benefits from Blaszczak, including free meals and tickets to sporting events, and Blaszczak recruited Worrall to join his consulting firm (though Worrall ended up not working there).

For each of the allegedly illegal trades, the government charged securities fraud under both Rule 10b-5 and 18 U.S.C. § 1348. (The government also charged conversion of government property, wire fraud and conspiracy.) On May 3, 2018, after a four-week trial, the jury returned a mixed verdict. The tipper, Worrall, was convicted solely on counts of wire fraud and conversion of government property; he was acquitted of both the Title 15 and Title 18 securities fraud charges. Blaszczak, the intermediate tippee, was acquitted of the Rule 10b-5 charges under Title 15, but found guilty under Section 1348. The downstream tippees, Huber and Olan, were both acquitted of insider trading under Rule 10b-5, but, like Blaszczak, found guilty of securities fraud under Section 1348. In sum, on the very same facts and trades, the jury returned convictions under Title 18 and acquittals under Title 15.

The Jury Instructions

The jury verdict is not entirely surprising given the stark differences in the elements of criminal liability under Rule 10b-5 and Section 1348, as reflected in Judge Kaplan's instructions to the jury.

As to Rule 10b-5, the instructions were very detailed, taking up 20 pages of transcript and presenting the jury with 10 specific issues to address, including, notably, whether the alleged tipper owed a duty of trust and confidence to CMS, the tipper expected a personal benefit in exchange for information, and the tippees knew both that information was disclosed in breach of a fiduciary duty of confidentiality, and that the tipper would receive a benefit for the disclosures. The jury had a clear, if demanding, road map to follow: if the jury answered "no" to any of the numerous questions it was given, the jury was required to return a verdict of not guilty.

> But alongside this convergence lies a distinct anomaly. As suggested in Blaszczak, the elements of civil liability for insider trading under Rule 10b-5 may be far more onerous than the elements of criminal liability under Title 18.

Whereas the elements of insider trading under Rule 10b-5 have been the subject of an elaborate jurisprudence, the elements of securities fraud under 18 U.S.C. § 1348 have received relatively little attention. Enacted in 2002 as Section 807(a) of the Sarbanes-Oxley Act, Section 1348 prohibits "executing, or attempting to execute, a scheme or artifice to defraud any person in connection with … any security of an issuer of a class of securities registered under Section 12 of the Securities Exchange Act of 1934." The language is patterned after the mail and wire fraud statutes, near which it is codified in Title 18.

The defense requested that the Section 1348 instructions track the instructions for Rule 10b-5, including language regarding breach of a fiduciary duty, personal benefit and personal knowledge. Judge Kaplan denied the request, and the court's instructions for Section 1348 were significantly different, occupying four pages of transcript.

The instructions defined "a scheme or artifice to defraud"—the first element—as follows:

The government alleges that the defendants engaged in an illegal scheme or artifice by taking the confidential information from CMS and transferring it to another person for the purpose of buying or selling securities on the basis of that information … You might find that the defendant you are considering participated in a scheme to defraud if you find that he participated in a scheme to embezzle or convert confidential information from CMS by wrongfully taking that information and transferring it to his own use or the use of someone else.

As to the mens rea element—acting knowingly and willfully with a specific intent to defraud—Judge Kaplan looked to Title 18 wire fraud; in fact, he instructed the jury to "follow the instruction from the wire fraud counts in that regard." The charge read as follows: "to act knowingly means to act intentionally, deliberately and voluntarily, rather than by mistake, accident, ignorance or carelessness. To act willfully means to act deliberately and with a purpose to do something that the law forbids." As to specific intent to defraud, Judge Kaplan instructed the jury that "the government must prove that he acted with the intent to deprive CMS of something of value—for example, confidential material, nonpublic information."

Absent from the instructions as to Section 1348 was any discussion of essential elements of tipper/tippee liability under Rule 10b-5: a tipper's breach of a fiduciary duty, personal benefit to the tipper and tippee knowledge of a breach of confidentiality and receipt of personal benefit. Under Section 1348, all the government needed to prove was the existence of a scheme to defraud, mens

rea and a connection to the purchase or sale of securities.

Carpenter Redux

The charges and jury instructions in *Blaszczak* recall the *Carpenter v. United States* case decided by the Supreme Court in 1987. In that case, a Wall Street Journal reporter and others were charged with insider trading based on tips about positive or negative stories about companies shortly before publication. The government brought criminal charges under both Rule 10b-5 and the mail and wire fraud statutes (18 U.S.C. §§ 1341 and 1343). The mail and wire fraud charges, like the securities fraud charges 30 years later in *Blaszczak*, rested on alleged thefts of confidential employer information. The defendants in *Carpenter* were convicted of both Rule 10b-5 and Title 18 fraud charges, and the convictions were affirmed by the Supreme Court. The Supreme Court held that "confidential business information has long been recognized as property," such that taking that property through deceptive means was sufficient to warrant a mail and wire fraud conviction. As to the Rule 10b-5 convictions, the court upheld the "misappropriation" theory of liability, albeit on a four-to-four vote, thus not clearly resolving the issue until the misappropriation theory was accepted by the Supreme Court by six votes in *United States v. O'Hagan,* 521 U.S. 642 (1997).

Notwithstanding the result in *Carpenter*, many high-profile insider trading cases, including many of the leading cases in recent years, have not included Title 18 fraud charges—under either the mail and wire fraud provisions (Sections 1341 and 1343) or the securities fraud provision added by the Sarbanes-Oxley Act in 2002 (Section 1348). In *United States v. Rajaratnam*, *United States v. Goffer*, *United States v. Gupta*, *United States v. Steinberg*, *United States v. Newman*, and *United States v. Martoma*, the indictments charged insider trading only in violation of Rule 10b-5—perhaps because, at the time these cases were brought, the difficulty of achieving and sustaining convictions under Rule 10b-5 had not yet become so clear.

The absence of Title 18 charges in the prosecution of Raj Rajaratnam is particularly noteworthy. In that case, the defense moved to suppress wiretap evidence on the grounds that securities fraud under Title 15 was not a predicate offense under Title III. The motion was denied because the government's wiretap application rested on probable cause of both wire fraud and money laundering – both predicate Title 18 offenses for electronic surveillance., see *United States v. Rajaratnam*, No. 09 Cr. 1184, 2010 WL 4867402 at *4 (Nov. 24, 2010). Yet, ironically, the resulting indictment of Rajaratnam did not include fraud charges under Title 18, only Rule 10b-5 charges.

Space does not permit a full discussion of the "squawk box" prosecutions in the Eastern District of New York, but the charges in that case were a noteworthy exception because they included Section 1348 violations. In denying a motion to dismiss those charges, Senior District Judge I. Leo Glasser, after noting that he could identify "no previous convictions under 18 U.S.C. § 1348," held that the government need not demonstrate an intent to cause loss, as the defense had argued, but instead simply needed to prove a scheme or artifice to defraud; connection with a security; and fraudulent intent, *United States v. Mahaffy*, No. 05 Cr. 613, 2006 WL 2224518 (Aug. 2, 2006). In defining a "scheme or artifice to defraud," the court analogized Section 1348 to both honest services fraud and to *Carpenter*, stating that "a jury could conclude that there existed a scheme either to deprive the brokerage firm and its clients of the intangible right to honest services, or the Brokerage Firms of their confidential information."

Conclusion

The charges in *Blaszczak* show the thread that ties together the various statutory provisions prohibiting insider trading. Regardless of the particular statute—Section 10(b) and Rule 10b-5, Section 1341 and 1343 or Section 1348—liability turns on the theft (or misappropriation) of confidential information from an employer or another entity to which a person owes a duty of confidentiality. Other facts and circumstances come into play, such as materiality, but theft and misuse of confidential information is the essence of the misconduct.

But alongside this convergence lies a distinct anomaly. As suggested in *Blaszczak*, the elements of civil liability for insider trading under Rule 10b-5 may be far more onerous than the elements of criminal liability under Title 18. This anomaly results from broadly worded statutes, adopted separately and over many decades, being interpreted in distinct lines of case law. We question whether the drafters of the laws at issue could have contemplated such a disparity in civil and criminal liability for the very same conduct. But that appears to be the legal landscape, as reflected in the jury verdict in *Blaszczak*. On appeal, the U.S. Court of Appeals for the Second Circuit will likely be asked to come to grips with this disparity.

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