Professional Perspective

Resolving The Personal-Benefit Anomaly In Insider-Trading Law

Michael R. Dreeben, O'Melveny & Myers,
Elizabeth N. Hadley & Conor S. O'Shea, Georgetown Law

Bloomberg Law

Read Professional Perspective | Become a Contributor

Resolving The Personal-Benefit Anomaly In Insider-Trading Law

Contributed by Michael R. Dreeben, O'Melveny & Myers,
Elizabeth N. Hadley & Conor S. O'Shea, Georgetown Law

An anomaly is haunting insider-trading law. Generally, criminal law punishes, stigmatizes, and deters morally culpable acts, while civil law provides remedies for injuries. That criminal/civil divide has deep roots in the law, tracing to Blackstone and classical works of legal philosophy. One might infer that proving a criminal insider-trading violation, with its greater consequences for liberty and social opprobrium, would be harder than proving a civil violation. Yet recent decisions from the US Court of Appeals for the Second Circuit have inverted that hierarchy for insider-trading tipper-tippee violations.

To establish civil liability for insider trading under Section 10(b) of the Securities Exchange Act and Rule 10b-5, which prohibit fraud in connection with the purchase and sale of securities, the government must prove that the tipper received a "personal benefit" for disclosing the inside information. *Dirks v. SEC*, 463 U.S. 646, 659, 662 (1983); see also *Salman v. United States*, 580 U.S. 39 (2016). But a Second Circuit panel held that the government does not have to prove the element of personal benefit to the insider to establish criminal liability under 18 U.S.C. § 1348, which makes it a crime, among other things, "to defraud any person in connection with . . . any [registered] security." See *United States v. Blaszczak (Blaszczak I)*, 947 F.3d 19, 34–37 (2d Cir. 2019), vacated and remanded, *Olan v. United States*, 141 S. Ct. 1040 (2021) (No. 20-306).

This upside-down development came under attack in a Second Circuit decision on remand from the US Supreme Court. *United States v. Blaszczak (Blaszczak II)*, 56 F.4th 230 (2d Cir. 2022). The remand did not concern securities law, but Judge John M. Walker, Jr., joined by Judge Amelia Kearse, concurred separately to brand the circuit's divergent standards in civil and criminal cases as "odd" and appealed to Congress to address the "glaring anomaly." Judge Richard J. Sullivan's dissent scolded the concurrence for writing a "gratuitous advisory opinion," but went on to reject the claim of anomaly based on his view that the civil/criminal distinction on the elements required to prove insider trading in tipper-tippee cases reflected valid, analytically distinct approaches.

Judge Walker's concurrence accurately identifies the civil/criminal anomaly as a problematic feature of circuit law: It is "odd" that a criminal tipper-tippee violation requires fewer elements of proof than a civil violation. But the solution lies directly at hand—and Congress need not get involved. Contrary to the Second Circuit's view, the Rule 10b-5 personal-benefit rule does apply to insider-trading prosecutions brought under the general criminal code. That is because both Rule 10b-5 and the criminal code's securities-antifraud provision trace their roots to the same soil: the common law of fraud. Because the personal-benefit rule announced under Rule 10b-5 springs directly from that common law source, it equally applies to the fraud provisions in the criminal code. Aligning those two bodies of law would provide the clear guidance to insiders, securities analysts, market participants, and counsel that Judge Walker desired. And it would resolve the legal incongruity that his concurrence highlighted.

An Insider-Trading Play in Three Acts: United States v. Blaszczak

The story begins with a government insider who tipped a friend, who tipped hedge-fund employees, who traded on the information. The insider worked at the Centers for Medicare & Medicaid Services where he had access to material, nonpublic information on proposed rule changes governing reimbursement rates for certain types of medical care. The insider revealed the information to a friend and former employee who consulted for hedge funds (Blaszczak), who in turn gave the information to two people at a hedge fund, who traded on it.

The government indicted all four—the tipper, the tippee, and the two traders—for insider trading under both Section 10(b) and Title 18, as well as for conspiracy and a variety of property crimes. The jury acquitted the defendants on the Section 10(b) counts, where the jury was instructed that it had to find that the insider disclosed the information for personal benefit. But the jury convicted the four of various property offenses and violations arising under the specific Title 18 prohibition of securities fraud, where no personal-benefit instruction was given in order for the jury to find that the tipper's disclosures could result in tippee liability.

On appeal, the defendants argued that proposed agency rulemaking changes were not "property" or a "thing of value," as the applicable fraud and conversion statutes required. The Second Circuit rejected that argument, affirming the convictions in *United States v. Blaszczak* (*Blaszczak I*). 947 F.3d at 30–34. And, as relevant here, the Second Circuit also upheld the use of Title 18's prohibition on securities fraud to prosecute insider trading—without requiring the government to prove that the insider disclosed the inside information for personal benefit.

The defendants sought certiorari in the Supreme Court, challenging the panel's holdings that agency information about a proposed rule constituted "property" and that the Title 18 fraud offenses could be established without proof that the insider acted for personal benefit. But before the Court considered whether to address those issues, it held in *Kelly v. United States*, the Bridgegate-scandal case, that regulatory decisions were not "property" or a "thing of value" and that the Title 18 statutes at issue in that case were not violated unless obtaining property was the object of the offense. 140 S. Ct. 1565 (2020). Given that development and at the government's suggestion, the Supreme Court vacated the judgments and remanded the case to the Second Circuit for reconsideration in light of *Kelly*. *Blaszczak v. United States*, 141 S. Ct. 1040 (2021).

Back before the Second Circuit, the panel now held—as the government conceded—that that predecisional agency information about proposed reimbursement rates was not "property," and it therefore vacated the defendants' conspiracy convictions and remanded certain other counts for the government to dismiss them in *Blaszczak II*. 56 F.4th at 246.

As for *Blaszczak I*'s other notable holding—that Title 18 securities fraud does not include the personal-benefit requirement that Title 15 securities law requires to prove a Section 10(b) insider-trading violation—the majority said nothing. But in separate opinions, the three members of the panel broke into two camps on the validity of that now-vacated holding. The holding has no formal precedential weight in light of the panel's decision to vacate the convictions and remand. But presumably to counter any lingering persuasive value, two members of the *Blaszczak II* panel wrote to express contrary views.

Judge Walker's concurrence spotlighted this issue. In his view, a legal regime that criminalizes conduct that the civil law permits creates a legal anomaly that should strike one as strange. He said the criminal-civil asymmetry also has real-world consequences: The easier path to proving a criminal violation chills the flow of information necessary to the healthy functioning of securities markets and leaves insiders, traders, and their lawyers with no clear sense of the boundaries of permissible conduct. *Blaszczak II*, 56 F.4th at 249 (Walker, J., concurring). In his view, the personal-benefit rule, while not perfect, clarifies "when the line is crossed." The disconnect between the civil and criminal standards, Judge Walker concluded, deserves "further attention by Congress and the courts."

Judge Sullivan's dissent defended the civil-criminal discrepancy. First, he found the discrepancy unremarkable in light of the proliferation of overlapping provisions in the federal criminal code—especially for offenses like fraud and misrepresentation. 56 F.4th 230 (Sullivan, J., dissenting) (citing William J. Stuntz, *The Pathological Politics of Criminal Law*, 100 Mich. L. Rev. 505, 600 n.62 (2001); *Pasquantino v. United States*, 544 U.S. 349, 358 n.4 (2005)).

Second, Judge Sullivan read *Dirks v. SEC*—the seminal Supreme Court case that announced the personal-benefit rule for Title 15 tipping cases—as a "judge-made rule premised on the statutory purpose of the Securities Exchange Act of 1934." Because Title 18 securities fraud is a different statute with a different purpose, Judge Sullivan found no reason to read a personal-benefit rule into it—and he saw no oddity in criminalizing conduct that would not support a civil securities violation.

Resolving the Anomaly

Judge Walker's concurrence persuasively identifies an anomaly in the law. But the solution does not require congressional action. Rather, the solution lies in the common-law of fraud and the recognition that the personal-benefit rule flows from that source—not from policy considerations in the securities laws. And because Title 18 securities fraud and the antifraud provisions in federal securities law share common text and derive from the same common-law roots, the Title 18 offense must include the personal-benefit rule, just like Title 15 securities fraud.

Judge Walker focused on the anomaly in requiring more elements to prove a civil violation under Section 10(b) than to prove a criminal violation under Section 1348, the Title 18 securities-fraud provision. But the same anomaly exists in allowing a tipper-tippee insider-trading violation to be proved under *any* criminal fraud statute, such as the mail- or wire-fraud statutes (18 U.S.C. §§ 1341, 1343), more easily than in a civil Section 10(b) action. And the same solution, discussed below, exists for both sets of laws.

The key to the analysis is that the Supreme Court did not read the personal-benefit rule into Title 15 securities fraud in *Dirks* as an exercise of judicial policymaking. Rather, the court "adapted the traditional meaning of fraud to the misuse of insider information for personal gain." Brief of Law Professors as *Amicus Curiae* in Support of Petitioners at 2, *Olan v. United States* (No. 20-306) (*Olan* Law Professors' Brief). In the securities context, the use of confidential information entrusted to one for a particular purpose becomes "fraudulent" only if it is used for one's own personal benefit rather than for a legitimate corporate purpose. See *Chiarella v. United States*, 445 U.S. 222, 232 (1980); *Dirks*, 463 U.S. at 653–54; *Olan* Law Professors' Brief at 10–11. This is because the deception, necessary to liability for fraud, arises when the fiduciary or other person having a duty of trust and confidence betrays that duty while continuing to pose as a loyal agent. See *United States v. O'Hagan*, 521 U.S. 642, 652–57, 660 (1997).

Using the information for personal benefit without disclosure is the central element in the fraud. And that personal-benefit rule, in turn, has its roots in the common law of corporations, agency, and embezzlement. *Olan* Law Professors' Brief at 10–13. In embezzlement, for example, a person may not "appropriate[e] *to [his] own use*," money or property that another "intrusted to him." *Grin v. Shine*, 187 U.S. 181, 189 (1902). That makes *Dirks*'s holding that Title 15 securities fraud includes the personal-benefit rule not some "judge-made doctrine," but a continuation of the common law as incorporated by Congress. *Olan* Law Professors' Brief at 13. Further cementing the connection between these bodies of law, the Supreme Court has analogized embezzlement to insider-trading law. See *O'Hagan*, 521 U.S. at 654.

Viewed against that backdrop, it becomes clear that Title 18 securities fraud—which flows from the same common-law understanding of fraud—must include the personal-benefit rule too. *Olan* Law Professors' Brief at 14. Congress used the same key words in defining Title 18 securities fraud that it had already used in the Title 15 securities fraud provisions, such as Section 10(b) of the Securities Exchange Act of 1934 and Section 17(a) of the Securities Act of 1933, as well as in the mail- and wire-fraud statutes. Compare 18 U.S.C. § 1348 with 15 U.S.C. § 78j(b); 15 U.S.C. § 77q(a); and 18 U.S.C. §§ 1341, 1343.

All of these laws prohibit a scheme or artifice to defraud in connection with securities, including by false or fraudulent representations. See *Olan Law Professors' Brief at 17*. Those textual similarities reveal that Congress did not intend to eliminate traditional securities-fraud elements in Title 18 securities-fraud cases, but instead to build on these established frameworks. See *Olan Law Professors' Brief at 17*. And that approach is consistent with the way in which the Supreme Court has previously relied on its wire-fraud precedent as a "source of guidance" in interpreting Section 10(b). *O'Hagan*, 521 U.S. at 654. Although the securities-fraud provision in 18 U.S.C. § 1348 was meant to streamline prosecutions of Enron-like scandals by avoiding technical requirements, it was not meant to divorce the anti-fraud protections at the core of Title 18's securities-fraud provisions from their common-law origin. See *Olan Law Professors' Brief at 14–16*.

Conclusion

Ultimately, because Title 18 securities fraud punishes only fraud, it therefore must incorporate the personal-benefit requirement that is indispensable to finding fraud in tipper-tippee insider-trading cases. Harmonizing these counterpart anti-fraud statutes not only resolves the anomaly that Judge Walker identified, it also avoids chilling the free flow of information between insiders and securities analysts that *Dirks* sought to protect and provides a workable line for insiders, traders, and their counsel to follow. And this harmonization can immediately be achieved by courts, without waiting for Congress to act.

