Missouri Law Review

Volume 86 | Issue 3 Article 10

Summer 2021

Insider Trading Under Sarbanes-Oxley: Bypassing the Personal Benefit Test

Andrew J. Meyer

NOTE

Insider Trading Under Sarbanes-Oxley: Bypassing the Personal Benefit Test

United States v. Blaszczak, 947 F.3d 19 (2d Cir. 2019)

Andrew J. Meyer[*]

I. INTRODUCTION

Insider trading is broadly defined as the use of material nonpublic information in connection with the trade of stock or other securities.[1] To the average person, the classic case of insider trading is a corporate executive reaping handsome personal profits by trading stock using insider information that he obtained through his position within the corporation. The reality, however, can be much more complicated.

While insider trading is generally illegal under federal law, the laws regulating it do not explicitly mention the term "insider trading."[2] In addition, not all forms of insider trading are prohibited.[3] Instead, a series of statutes and rules that prohibit fraud more generally are the basis for prosecuting insider trading.[4] Specifically, Section 10(b) of the Securities and Exchange Act of 1934 ("Exchange Act") and Rule 10b-5, promulgated by the Securities and Exchange Commission ("SEC"), bar persons from

---

[*] B.S. Computer Engineering, B.S. Electrical Engineering, Missouri University of Science & Technology, 2011; J.D. Candidate, University of Missouri School of Law, 2022; Associate Member, *Missouri Law Review*, 2020-2021. I would like to thank Professor Thom Lambert and Jessica Schmitz for their insight, guidance, and support during the writing of this Note, as well as the *Missouri Law Review* for its help in the editing process.

1. Akhilesh Ganti, *Insider Trading* (Feb. 25, 2021), https://www.investopedia.com/terms/i/insidertrading.asp [https://perma.cc/LS3A-ET78].

2. Karen E. Woody, *The New Insider Trading*, 52 ARIZ. ST. L.J. 594, 600 (2020).

3. *Id.* at 596.

4. *Id.* at 597.

committing fraud in connection with the sale or purchase of any security.[5] Because those who engage in insider trading typically make no affirmative representation when they trade securities, any "fraud" would have to consist of a failure to speak in the face of a duty to do so.[6] Thus, the courts have found insider trading liability where a person has a duty to speak before trading but instead remains silent.[7] In other words, an insider at a corporation owes a duty to the shareholders of the corporation because he is an agent of it.[8] Therefore, the insider has a duty to disclose any material nonpublic information to the person on the other end of the security transaction prior to its completion.[9] For example, the failure of a CEO to publicly disclose the loss of a lucrative business opportunity prior to selling his stock in the corporation would be fraud under Section 10(b) and Rule 10b-5.[10]

Insiders clearly have a duty to disclose; however, not all traders that use material nonpublic information are insiders to a corporation.[11] These outsider traders generally receive information from an insider in the form of a tip. To expand liability to these individuals, the United States Supreme Court created the personal benefit test.[12] The personal benefit test determines when the recipient of a tip ("tippee") inherits a duty to disclose from the source of the tip ("tipper").[13] The test states that a tippee inherits a duty when the tipper shares material nonpublic information for personal benefit, and the tippee knows, or should know, that the tipper breached his duty in sharing it.[14]

In 2002, Congress enacted a new securities fraud provision, 18 U.S.C. § 1348, under the Sarbanes-Oxley Act ("Sarbanes-Oxley").[15] Congress created this criminal statute in response to the scandals of Enron,

5. 15 U.S.C. § 78j(2)(b); 17 C.F.R. § 240.10b-5.

6. Chiarella v. United States, 445 U.S. 222, 228–29 (1980). "One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated…matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them…." Restatement (Second) of Torts § 551 (1977).

7. *See* Sec. & Exch. Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833, 861–62 (2d Cir. 1968).

8. *Id.*

9. *Id.*

10. *Id.*

11. *See id.*

12. *See* Dirks v. S.E.C., 463 U.S. 646, 663–64 (1983).

13. *Id.* at 662.

14. Woody, *supra* note 2, at 607–08.

15. *Id.* at 615.

Global Crossing, Worldcom, and Adelphia, and it contains language similar to that of Rule 10b-5.[16] Section 1348 was largely ignored for years, but a 2019 decision in the United States Court of Appeals for the Second Circuit brought it to the forefront.[17] In *United States v. Blaszczak*, the Second Circuit considered whether the personal benefit test should extend to the newer Section 1348 securities provision.[18] There, a tipper and tippees were charged with securities fraud under Rule 10b-5 and Section 1348.[19] At trial, the jury acquitted the defendants of securities fraud under Rule 10b-5, but convicted them under Section 1348.[20] The trial court instructed the jury to use the personal benefit test for the Rule 10b-5 charges but *not* for the Section 1348 charges.[21] On appeal, the Second Circuit affirmed the trial court's decision and held that when a person is charged with securities fraud under Section 1348, the personal benefit test from Rule 10b-5 securities fraud jurisprudence does not apply.[22]

---

16. Michael A. Perino, *Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, 76 ST. JOHN'S L. REV. 671, 671–72 (2002); Woody, *supra* note 2, at 616.

17. Woody, *supra* note 2, at 618–19.

18. United States v. Blaszczak, 947 F.3d 19, 26 (2d Cir. 2019).

19. *Id.*

20. *Id.*

21. *Id.* at 29.

22. *Id.* at 37. In September 2020, three of the defendants in *Blaszczak* petitioned for certiorari with the United States Supreme Court. *See* Petition for a Writ of Certiorari and Motion for Leave to Proceed in Forma Pauperis, Blaszczak v. United States, 141 S.Ct. 1040 (2021) (No. 20-5649); On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit at 35, Olan v. United States, 141 S.Ct. 1040 (2021) (No. 20-306). The Court granted the petition on January 11, 2021, vacated the judgment, and remanded it back the United States Court of Appeals for the Second Circuit. *Blaszczak*,141 S.Ct. at 1040; *Olan*, 141 S.Ct. at 1040. The Court instructed the Second Circuit to further consider the case in light of *Kelly v. United States*, 140 S. Ct. 1565 (2020). *Blaszczak*,141 S.Ct. at 1040; *Olan*, 141 S.Ct. at 1040. In *Kelly*, the Court held that a political revenge scheme by state officials to close lanes on the George Washington Bridge in Fort Lee, New Jersey was an exercise of regulatory power and not a scheme of money or property under 18 U.S.C. §§ 666, 1343 (2018). 140 S. Ct. at 1574. *Kelly* is important because there is a question in *Blaszczak* as to whether confidential government information is property for the purposes of the fraud statutes in Title 18. *Id.*; *Blaszczak*, 947 F.3d at 34. In *Blaszczak*, the defendants were convicted of fraud under Section 1343 in addition to 18 U.S.C. § 1348. 947 F.3d at 45. The Dissent in *Blaszczak* argued that confidential government information is not property under the Title 18 fraud statutes. *Id.* at 47–48 (Kearse, J., dissenting). When vacating the judgment and remanding the case, the Court did not instruct the Second Circuit to reconsider the other issue of *Blaszczak* which is the topic of this Note. *See* 141 S.Ct. at 1040; *Olan*, 141 S.Ct. at 1040. That issue is whether the personal benefit test applies to Section 1348. *See Blaszczak*, 947 F.3d at 30–37. On

This Note will discuss the history of insider trading law and analyze the reasoning of the Second Circuit. Part II outlines the facts and holding of *Blaszczak*, Part III analyzes the background and theories of insider trading liability under Rule 10b-5 and Section 1348, and Part IV describes the Second Circuit's decision in *Blaszczak*. Finally, Part V critiques the Second Circuit's decision and suggests changes to the future of insider trading law.

II. FACTS AND HOLDING

Between 2009 and 2014, defendants David Blaszczak, Theodore Huber, Robert Olan, and Christopher Worrall engaged in two schemes to pass and use confidential government information from the Centers for Medicare & Medicaid Services ("CMS") to make securities trades.[23] Worrall worked at CMS, Blaszczak worked as a "political intelligence" consultant for hedge funds, and Huber and Olan worked at Deerfield Management, L.P., a healthcare-focused hedge fund.[24]

CMS is a federal agency within the United States Department of Health and Human Services that manages and administers large government health programs including Medicare, Medicaid, and the Children's Health Insurance Program.[25] As a regulatory agency, the rules CMS adopts affect businesses and organizations within the health industry.[26] Specifically, CMS determines reimbursement rates for medical treatments covered by the health programs it manages.[27]

April 2, 2021, the Department of Justice filed a post-remand brief that conceded that, in light of *Kelly*, confidential government information is not property under the Title Title 18 fraud statutes. David E. Brodsky et. al., *DOJ Concedes Error In Title 18 Insider Trading Convictions After Supreme Court's "Bridgegate" Decision*, CLEARLY GOTTLIEB (Apr. 13, 2021), https://www.clearyenforcementwatch.com/2021/04/doj-concedes-error-in-title-18-insider-trading-convictions-after-supreme-courts-bridgegate-decision/ [https://perma.cc/FX6E-U5TB]. As a result, the Department of Justice asked the Second Circuit to reverse the Title 18 convictions. *Id.* As of the time of publication, it is unknown what will happen with the Second Circuit's prior holding on the personal benefit test because it does not need to revisit the issue if it reverses the Title 18 convictions. *Id.*

23. *Id.* at 26.

24. *Id.*

25. Julia Kagan, *Centers for Medicare & Medicaid Services (CMS)*, INVESTOPEDIA (Mar. 29, 2020), https://www.investopedia.com/terms/u/us-centers-medicare-and-medicaid-services-cms.asp [https://perma.cc/S8CQ-GMWY].

26. *Blaszczak*, 947 F.3d at 47 (Kearse, J., dissenting).

27. *Id.*

The first scheme involved Blaszczak passing confidential information from CMS about upcoming reimbursement rate changes for medical treatments to Huber and Olan.[28] Prior to becoming a hedge fund consultant, Blaszczak worked at CMS along with fellow defendant Worrall, one of Blaszczak's sources.[29] Defendants Huber and Olan approached Blaszczak to obtain confidential CMS information because they knew Blaszczak enjoyed unique access to this information through his sources at the agency.[30] On four separate occasions, Blaszczak passed confidential information about pending reimbursement rate changes to Huber and Olan, which they used to make stock trades on several companies that would be affected by the changes.[31] In one instance, Huber and Olan received information from Blaszczak about a reduction in the reimbursement rate for certain radiation oncology treatments.[32] Huber and Olan then used this confidential information to enter orders that "shorted" approximately thirty-three million dollars' worth of stock in a radiation device manufacturer.[33] When shorting a stock, a person bets that the stock price will decrease and he profits when it does.[34] In other words, Huber and Olan bet that the manufacturer's stock price would decrease after the information became public, which, in this case, resulted in a profit of over two million dollars.[35] Huber and Olan believed that Blaszczak's information gave them an edge in the market, and through these trades, Huber and Olan's hedge fund accumulated approximately seven million

28. *Id.* at 27 (majority).

29. *Id.* at 26–27.

30. *Id.*

31. *Id.* at 27.

32. *Id.*

33. *Id.*

34. Shorting a stock or short selling is a trading strategy where a person hopes to profit by betting that the stock price of a company will go down. Adam Hayes, *Short Selling*, INVESTOPEDIA (Mar. 13, 2021), https://www.investopedia.com/terms/s/shortselling.asp [https://perma.cc/B3W6-ZMF3]. For example, Person A short sells by borrowing a stock from Person B and selling it to Person C at the current market price. *Id.* Person A then plans to re-buy the stock at a lower price, return it to Person B, and then pocket the difference. *Id.* However, this is a highly speculative trading strategy that has a risk of unlimited loss because a stock price can theoretically increase to infinity. *Id.* Therefore, if the stock price does not decrease, Person A needs to buy the stock back at a higher price in order to return the stock to Person B. *Id.*

35. *Blaszczak*, 947 F.3d at 27.

dollars in profits.[36] They described their relationship with Blaszczak as a "money printing machine."[37]

In the second scheme, which occurred around the same time as the first, Blaszczak shared similar confidential information with Christopher Plaford at another hedge fund.[38] Like Huber and Olan, Plaford also believed that the information provided by Blaszczak gave him an edge in the market and that it was more accurate than that from other sources because Blaszczak's information originated from the "horse's mouth."[39] Plaford used the confidential information to make trades similar to those made by Huber and Olan.[40] On one occasion, Plaford accumulated approximately $330,000 in profit.[41]

The United States Department of Justice ("DOJ") filed an eighteen-count indictment related to these two trading schemes.[42] The charges included conspiracy centering on misappropriation of confidential information, conversion of United States property, wire fraud, securities fraud under Rule 10b-5, and securities fraud under Section 1348.[43]

The DOJ tried the case before a jury starting on April 2, 2018.[44] Because none of the defendants apart from Worrall owed a duty to speak before trading, they would have to inherit such a duty under existing Rule 10b-5 precedents.[45] Accordingly, the jury instructions for the Rule 10b-5 securities fraud counts included the personal benefit test.[46] Specifically, the trial court instructed the jury that in order to convict the defendants of securities fraud under Rule 10b-5, the government needed to prove that Worrall, who owed a duty to CMS as an employee, tipped confidential information in exchange for a personal benefit, and that each of the other defendants knew that Worrall disclosed the information in exchange for a personal benefit.[47] The trial court, however, denied the defendants'

36. *Id.* at 27–28.

37. *Id.* at 27.

38. *Id.* at 28. Plaford was a portfolio manager at Visium Asset Management, L.P. who pleaded guilty and testified against Blaszczak as a cooperating witness. *Id.*

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.* at 28–29.

43. *Id.* at 26, 29. The court in *Blaszczak* refers to § 10(b) and Rule 10b-5 as Title 15 securities fraud and refers to § 1348 as Title 18 securities fraud. *Id.* at 26.

44. *Id.* at 29.

45. *Id.* at 26 (Worrall was an employee of CMS and therefore owed a duty as an agent while the others were outsiders and had no pre-existing duty).

46. *Id.* at 29.

47. *Id.*

request to include the personal benefit test in the Section 1348 securities fraud instructions.[48] Instead, the trial court instructed the jury that in order to convict the defendants of Section 1348 securities fraud, the government needed to prove only that the defendants knowingly and willingly participated in a fraudulent scheme to embezzle or convert confidential information by "wrongfully taking the information and transferring it to his own use or the use of someone else."[49] The jury instructions for the Rule 10b-5 charges covered fourteen pages of the trial transcript and included ten elements, whereas the Section 1348 instructions spanned fewer than five pages.[50] The jury returned a verdict on May 3, 2018, which acquitted all defendants of the Rule 10b-5 securities charges, but convicted Blaszczak, Huber, and Olan of the Section 1348 securities charges.[51]

On appeal to the Second Circuit, the defendants argued that the trial court erred in refusing to include the personal benefit test in the jury instructions for securities fraud under Section 1348.[52] The court held that when a person is charged with securities fraud under Section 1348, the Rule 10b-5 personal benefit test does not apply.[53]

III. LEGAL BACKGROUND

In the United States, Section 10(b) of the Exchange Act and SEC Rule 10b-5 are the primary bases for prosecuting insider trading. Over the years, federal courts crafted insider trading law by interpreting Rule 10b-5 to cover such conduct.[54] More recently, the Section 1348 fraud provision of Sarbanes-Oxley has also been used by the DOJ to prosecute insider trading.[55] This section will first discuss the history of insider trading under

48. *Id.*

49. *Id.*

50. Antonia M. Apps & Katherine R. Goldstein, *Can the Government Circumvent "Newman's" Personal Benefit Test?*, 262 N.Y. L.J. 1, 2 (2019), https://www.milbank.com/images/content/1/2/v2/126268/NYLJ-12.02.2019-Milbank.pdf [https://perma.cc/K64V-SQRT].

51. *Blaszczak*, 947 F.3d at 29–30.

52. *Id.* The defendants challenged their convictions on several other grounds arguing that (1) confidential CMS information is not property for the purposes of Title 18 wire and securities fraud, (2) the defendants' convictions were affected by legal and factual errors, (3) the evidence was insufficient, (4) there was a misjoinder of counts for Blaszczak, and (5) the district court made evidentiary errors. *Id.* at 30.

53. *Id.* at 37.

54. *See, e.g.*, Sec. & Exch. Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833, 843 (2d Cir. 1968); Chiarella v. United States, 445 U.S. 222, 224 (1980); Dirks v. S.E.C., 463 U.S. 646 (1983).

55. *See, e.g.*, *Blaszczak*, 947 F.3d at 29.

Section 10(b) and Rule 10b-5, including the main theories for liability developed by the courts. Then, it will address the fraud provision of Section 1348.

A. Theories of Liability under SEC Rule 10b-5

Section 10(b) of the Exchange Act prohibits those buying or selling securities from using "any manipulative or deceptive device or contrivance in contravention" of rules or regulations prescribed by the SEC.[56] In 1942, the SEC adopted Rule 10b-5 based upon the authority of Section 10(b).[57] Rule 10b-5 provides that it is unlawful for any person, either directly or indirectly, to employ any device, scheme, or artifice to defraud in connection with the purchase or sale of any security.[58] The SEC originally adopted Rule 10b-5 to address securities fraud and not insider trading. In the 1960s, however, the SEC started to use the rule to combat an increasing number of insider trading cases.[59]

Over the years, the courts interpreted Rule 10b-5 to forbid insider trading, and several of those pivotal cases provide the basic framework of insider trading law today. Initially, the courts developed the Disclose or Abstain Doctrine to cover any persons using material nonpublic information.[60] Then, they limited liability to only insiders with fiduciary

56. 15 U.S.C. § 78j ("It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange… [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors . . . .").

57. Zachary J. Gubler, *Insider Trading As Fraud*, 98 N.C. L. Rev. 533, 542 (2020).

58. 17 C.F.R. § 240.10b-5 ("It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.").

59. Gubler, *supra* note 57, at 542–53.

60. *See* Sec. & Exch. Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833, 843 (2d Cir. 1968).

duties under the Classical Theory.[61] Next, they expanded liability to outsiders without fiduciary duties by creating the personal benefit test.[62] Finally, they created liability for complete outsiders to a company under the Misappropriation Theory.[63]

1. The Early Days and the Disclose or Abstain Doctrine

In *SEC v. Texas Gulf Sulphur*, a company performing exploratory drilling on a parcel of land discovered valuable minerals.[64] To facilitate the acquisition of the property, the president of the company ordered the exploration group to keep the results of the drilling confidential.[65] The president did not inform the company's stock option committee or its board of directors about the mineral find.[66] Before the information became public, several insiders at the company made stock trades based on the information.[67] From the time the drilling began to the time the information became public, the stock price increased from approximately seventeen dollars per share to over fifty-eight dollars per share.[68] The SEC filed a complaint against the insiders for violating Rule 10b-5. The trial court found some of the insiders guilty and dismissed the charges against the others.[69] On appeal, however, the Second Circuit affirmed the findings of guilt but reversed the dismissals.[70] It held that anyone possessing material inside information must either disclose the information before trading in securities or abstain from trading if unable to disclose.[71] The court reasoned that the purpose of Rule 10b-5 was to ensure that all investors should have relatively equal access to material information.[72] The court found that the defendants violated Rule 10b-5 by not disclosing the

61. *See* Chiarella v. United States, 445 U.S. 222, 224 (1980).

62. *See* Dirks v. S.E.C., 463 U.S. 646 (1983).

63. *See* Carpenter v. U.S., 484 U.S. 19 (1987); U.S. v. O'Hagan, 521 U.S. 642 (1997).

64. *Tex. Gulf Sulphur Co.*, 401 F.2d at 843.

65. *Id.*

66. *Id.* at 844.

67. *Id.*

68. *Id.* at 847.

69. *Id.* at 839, 842.

70. *Id.* at 842–43.

71. *Id.* at 848.

72. *Id.*

information or abstaining from trading.[73] This became known as the Disclose or Abstain Doctrine.[74]

2. The Classical Theory of Insider Trading and The Personal Benefit Test

The Disclose or Abstain Doctrine from Texas Gulf Sulphur remained the primary rule regarding insider trading until the 1980s.[75] Subsequently, two cases, *Chiarella v. United States* and *Dirks v. SEC*, reshaped insider-trading law by limiting liability from anyone possessing inside information to only those who owe a fiduciary duty.[76] This is known as the Classical Theory of insider trading.[77]

In *Chiarella*, an employee of a printing company determined the identity of corporations being targeted in takeover bids by examining documents used in the process of printing takeover announcements.[78] Using this information, and without disclosing it, Chiarella purchased stock in the target corporations and immediately sold the stock after the takeover bid was made public.[79] Chiarella gained approximately $30,000 in profit over fourteen months through those trades.[80] The trial court convicted Chiarella on seventeen counts of violating Rule 10b-5, and he appealed to the United States Supreme Court.[81] The Court held that Chiarella's failure to disclose the information was not fraud under Rule 10b-5.[82] The Court reasoned that, under common law, a failure to disclose material information before a transaction is fraud only when there is a duty to speak.[83] In this instance, Chiarella had no duty because he was not an agent of the target corporations, and therefore owed no duty to the shareholders whose stock he purchased.[84] Rather, Chiarella was a

73. *Id.*

74. *See* Woody, *supra* note 2, at 603.

75. *Id.*

76. *Id.* at 604.

77. Bradley J. Bondi & Steven D. Lofchie, *The Law of Insider Trading: Legal Theories, Common Defenses, and Best Practices for Ensuring Compliance*, 8 N.Y.U. J.L. & BUS. 151, 157 (2011).

78. Chiarella v. United States, 445 U.S. 222, 224 (1980).

79. *Id.*

80. *Id.*

81. *Id.* at 225.

82. *Id.*

83. *Id.* at 228.

84. *Id.* at 232.

"complete stranger" to his trading partners.[85] For there to have been a duty for Chiarella to speak, a duty to all participants in market transactions would need to exist.[86] The Court declined to recognize such a duty because doing so would depart "radically from the established doctrine that duty arises from a specific relationship between two parties…."[87] The Court did not find any intent from Congress or the SEC to warrant such a departure.[88]

Dirks v. SEC built upon *Chiarella* by creating the personal benefit test for situations where an insider, a tipper, tips information to an outsider, a tippee.[89] In *Dirks*, Raymond Dirks, a securities analyst, received information about accounting fraud at a corporation that sold life insurance and mutual funds from Ronald Secrist, a former officer of the corporation.[90] Dirks investigated the fraud and disclosed his findings to the Wall Street Journal which refused to publish the story.[91] While Dirks and his company did not trade on the corporation's stock, Dirks openly discussed his investigation with several clients and investors who used the information to make trades.[92] After the stock price began to fall precipitously, the SEC filed a complaint against the corporation committing accounting fraud and opened an investigation into Dirks.[93] At an administrative hearing, the SEC found that Dirks violated Rule 10b-5, among other laws, by sharing the fraud allegations with the investor community.[94] The SEC reasoned that although Dirks was an outsider, and therefore did not have an existing fiduciary duty to the corporation, Dirks inherited Secrist's fiduciary duty by knowingly receiving the information.[95] The United States Court of Appeals for the District of Columbia Circuit affirmed the SEC's findings.[96]

The United States Supreme Court reversed the D.C. Circuit's ruling, finding that Dirks did not violate Rule 10b-5 because Secrist did not receive a personal benefit for disclosing the information.[97] The Court's

85. *Id.* at 232–33.
86. *Id.* at 233.
87. *Id.*
88. *Id.*
89. Dirks v. S.E.C., 463 U.S. 646 (1983).
90. *Id.* at 648–49.
91. *Id.* at 649–50.
92. *Id.* at 649.
93. *Id.* at 650.
94. *Id.* at 650–51.
95. *Id.* at 655–56.
96. *Id.* at 652.
97. *Id.* at 652.

analysis initially reaffirmed the holding in *Chiarella* in that there cannot be a violation of Rule 10b-5 unless there is a breach of a duty.[98] However, the Court stated that a tippee does not acquire a duty merely by receiving material nonpublic information from an insider who does owe a duty.[99] Instead, the tippee inherits a duty by receiving the information improperly.[100] This occurs when (1) an insider-tipper breaches his duty by sharing the information, and (2) the tippee knows or should have known there has been a breach by the insider.[101]

The Court then turned to the question of what constitutes a breach on the part of the insider.[102] In answering that question, the Court noted that not all disclosures of material nonpublic information constitute a breach of the insider's duty to the shareholders.[103] The Court explained that in some cases, whether information is material and whether it is nonpublic, might not be apparent to an insider.[104] The Court acknowledged that the purpose of the securities laws is to eliminate the use of material nonpublic information for *personal* advantage.[105] Thus, the Court reasoned that an insider must receive a personal gain either directly or indirectly for there to be a breach of duty, and if there is no breach of duty by the insider, then there is no breach by the tippee.[106] In this case, the Court held that neither Secrist, Dirks, nor Dirks's clients committed insider trading because Secrist did not gain a personal benefit for tipping off Dirks, which meant that neither Dirks nor his clients who traded inherited a duty to disclose the information before trading.[107]

The preceding cases, among others, created doctrines known as the Classical Theory of insider trading and the personal benefit test for inheriting a duty to speak before trading. As exemplified by *Chiarella*, the Classical Theory holds that an insider commits insider trading by failing to disclose his material nonpublic information to a trading partner to whom the insider owes a duty to disclose.[108] The personal benefit test, shown by *Dirks*, holds that a tippee inherits the duty of the tipper when the tippee knows or should have known that the tipper breached his duty by

98. *Id* at 654.
99. *Id.* at 660.
100. *Id.*
101. *Id.*
102. *Id.* at 661.
103. *Id.* at 661–62.
104. *Id.* at 662.
105. *Id.*
106. *Id.*
107. *Id.* at 666–67.
108. Chiarella v. United States, 445 U.S. 222, 232 (1980).

providing material nonpublic information in exchange for a personal benefit.[109]

3. The Misappropriation Theory of Insider Trading

While the classical theory and the personal benefit test covered situations where an insider breaches his fiduciary duty by either using the information or tipping it to another for personal benefit, another theory of insider trading emerged after *Chiarella* and *Dirks*.[110] The misappropriation theory developed to cover situations where an outsider breaches a duty arising out of a relationship of trust or confidence and he misappropriates and uses material nonpublic information in a securities transaction.[111] In contrast to the classical theory, the misappropriation theory involves fraud against the source of the material nonpublic information instead of the buyer or seller of a security.[112]

The United States Supreme Court first addressed the misappropriation theory as applied to Rule 10b-5 in *Carpenter v. United States*.[113] In *Carpenter*, a reporter wrote a daily column in the Wall Street Journal that discussed selected stocks and gave a positive or negative analysis about them.[114] The information and the analysis in the column did not come from an insider at a corporation, but the column had the potential to impact stock prices after publication.[115] The Journal had a policy that the contents of the column were its property and that they were to remain confidential before publication.[116] The reporter and other defendants, however, entered into a scheme to pass along the column's contents and to make trades upon it.[117] In total, the defendants made a profit of approximately $690,000.[118]

---

109. *Dirks*, 463 U.S. at 660. The tipper in such a situation is liable because sharing material nonpublic information to obtain a personal benefit is tantamount to trading on the information; the personal benefit test is merely a substitute for trading gains. *Id.* at 663–64.

110. *Chiarella*, 445 U.S. at 232; *Dirks*, 463 U.S. at 660.

111. George F. Gabel, Jr., Annotation, *Who may be liable under "misappropriation theory" of imposing duty to disclose or abstain from trading under § 10(b) of Securities Exchange Act of 1934 (15 U.S.C.A. § 78j(b)) and SEC Rule 10b–5 (17 CFR § 240.10b–5)*, 114 A.L.R. Fed. 323 (1993).

112. *Id.*

113. Carpenter v. United States, 484 U.S. 19 (1987).

114. *Id.* at 22.

115. *Id.*

116. *Id.* at 23.

117. *Id.*

118. *Id.*

The United States District Court for the Southern District of New York and the Second Circuit found the reporter guilty of violating Rule 10b-5 because he breached his duty of confidentiality to the Journal by misappropriating the column's confidential contents.[119] Both courts reasoned that, although the Journal was not a buyer or seller of stock in these transactions, the Journal was the victim of the fraud and the fraud fell within the definition of Rule 10b-5 because it was "in connection with" the purchase or sale of securities.[120] On appeal to the United States Supreme Court, the justices split equally on the question of whether Rule 10b-5 reached the defendant's conduct and that equal division resulted in affirmance of the Second Circuit's decision.[121]

In addition to the charges under Rule 10b-5, the reporter in *Carpenter* was also charged with and convicted of mail and wire fraud under Title 18 of the United States Code.[122] The mail fraud statute, 18 U.S.C. § 1341, and the wire fraud statute, 18 U.S.C. § 1343, each prohibit a scheme or artifice to defraud by means of the mail or by wire, radio, or television.[123] The United States Supreme Court affirmed the convictions, holding that the conspiracy to trade in the Journal's confidential information fell within the mail and wire fraud statutes.[124] The Court reasoned that the Title 18

119. *Id.* at 23–24.

120. *Id.* at 24.

121. *Id.*

122. *Id.* at 21.

123. *See* 18 U.S.C. § 1341 ("Whoever, having devised or intending to devise any *scheme or artifice to defraud*, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places *in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or deposits or causes to be deposited any matter or thing whatever to be sent or delivered by any private or commercial interstate carrier*, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail or such carrier according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing….") (emphasis added); s*ee also* 18 U.S.C. § 1343 ("Whoever, having devised or intending to devise any *scheme or artifice to defraud*, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted *by means of wire, radio, or television communication* in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice….") (emphasis added).

124. *Carpenter*, 484 U.S. at 27–28.

mail and wire fraud statutes reach any scheme that uses false or fraudulent pretenses to deprive another of his money or property.[125] The Court stated that the term "defraud" in the Title 18 statutes had a common understanding of wronging a person of his property rights by dishonest schemes and that fraud includes the act of embezzlement which is a fraudulent appropriation of money or goods for personal use by a person entrusted to care for the money or goods.[126] It also stated that "a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principal for any profits derived therefrom."[127] Thus, while the Court in *Carpenter* did not explicitly endorse the misappropriation theory as applied to fraud in Rule 10b-5, it unanimously adopted the misappropriation or embezzlement theory as it applies to fraud in the Title 18 statutes.[128]

The United States Supreme Court revisited the question of whether the misappropriation theory applies to Rule 10b-5 in *United States v. O'Hagan*.[129] In *O'Hagan*, a partner in a law firm obtained confidential information regarding a client's offer to purchase another corporation.[130] The partner did not represent the client, but received the information from fellow partners working with the client.[131] The partner used this information to purchase stock options in the target corporation, which resulted in profits of more than four million dollars.[132] A jury found the partner guilty of violating Rule 10b-5, but the United States Court of Appeals for the Eighth Circuit reversed, holding that liability under Rule 10b-5 cannot be grounded on the misappropriation theory of securities fraud.[133]

The United States Supreme Court reversed the Eighth Circuit on this last point.[134] The Court reasoned that the misappropriation theory satisfied Rule 10b-5's requirement that there be a "deceptive device" in connection with the purchase or sale of securities.[135] The Court described the fraud in

125. *Id.* at 27.
126. *Id.*
127. *Id.* at 27–28.
128. *Id.*
129. 521 U.S. 642 (1997).
130. *Id.* at 647.
131. *Id.*
132. *Id.* at 647–48.
133. *Id.* at 649.
134. *Id.* at 650.
135. *Id.* at 653.

Rule 10b-5 as of the "same species" as the fraud of the Title 18 mail and wire fraud statutes addressed in *Carpenter*.[136] It acknowledged the *Carpenter* Court's observation that the misappropriation of confidential information in violation of a fiduciary duty is fraud akin to embezzlement.[137] In clarifying that the misappropriator's deception consists of pretending loyalty to the source of the information while converting that source's information for personal gain, the Court in *O'Hagan* explicitly applied the misappropriation theory of insider trading to Rule 10b-5.[138]

B. Securities Fraud Under Section 1348

In 2002, the United States Congress created a new securities fraud provision, 18 U.S.C. § 1348, modeled after the Title 18 mail and wire fraud provisions discussed above.[139] Section 1348 prohibits the use of any scheme or artifice to defraud any person in connection with any security and forbids obtaining any security through false or fraudulent pretenses.[140]

Congress created Section 1348 through the passage of the Sarbanes-Oxley Act.[141] After the implosion of Enron and a string of other scandals involving Global Crossing, Worldcom, and Adelphia, legislators crafted Sarbanes-Oxley at "lightning speed" amongst a political firestorm, a falling Dow Jones Industrial Average, and an election year, which all led

136. *Id.* at 654.

137. *Id.*

138. *Id.* at 653–54. Justice Ginsburg notes in the opinion that the fraud in a misappropriation case consists of "feigning fidelity to the source of information." *Id.* at 655.

139. Woody, *supra* note 2, at 615; *see supra* note 123 (text of Title 18 mail and wire fraud statutes).

140. *See* 18 U.S.C. § 1348 ("Whoever knowingly executes, or attempts to execute, a scheme or artifice—(1) to defraud any person in connection with any commodity for future delivery, or any option on a commodity for future delivery, or any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78*l*) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*(d)); or (2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any commodity for future delivery, or any option on a commodity for future delivery, or any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78*l*) or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*(d)); shall be fined under this title, or imprisoned not more than 25 years, or both.").

141. Woody, *supra* note 2, at 615.

to its near unanimous passage.[142] The collapse of Enron and its auditor, Arthur Anderson LLP, politically weakened two groups affected by the legislation, the business community and the accounting profession.[143] As a result, "[t]he healthy ventilation of issues that occurs in the usual give-and-take negotiations over competing policy positions, which works to improve the quality of decisionmaking [sic], did not occur in the case of [Sarbanes-Oxley]."[144] Legislators did not attempt to reconcile their policy proposals with conflicting literature nor did they follow up on comments that "hinted at the existence of studies inconsistent with those [proposals]."[145] Furthermore, legislators typically sympathetic to the business community acquiesced and determined "that it would be politically perilous to be perceived as obstructing the legislative process and portrayed as being on the wrong side of the issue."[146] These circumstances resulted in a disorganized statute that spanned 150 pages of text and affected three separate titles of federal law.[147] The Act also created provisions that were duplicative and inconsistent with existing laws.[148] As one commentator stated, "it is reasonable to expect, as with other recent securities legislation, that significant unintended consequences will arise."[149]

According to a Senate Report from the Judiciary Committee on Sarbanes-Oxley, Congress added Section 1348 to provide a provision in the criminal code through which securities fraud could be prosecuted.[150] Before Sarbanes-Oxley, prosecutors relied upon either existing mail and wire fraud charges or specific existing securities laws or regulations such as Rule 10b-5 that contained technical legal requirements.[151] These methods proved to be challenging because prosecutors had to prove use of the mail or wires to carry out the fraud, and defendants could rebut arguments they possessed the requisite criminal intent with technical legal requirements.[152]

142. Perino, *supra* note 16, at 671–72.

143. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1528 (2005).

144. *Id.*

145. *Id.*

146. *Id.*

147. Perino, *supra* note 16, at 672.

148. *Id.*

149. *Id.* at 674.

150. S. REP. NO. 107-146, at 2 (2002).

151. *Id.* at 6.

152. *Id.*

The Senate Report on Sarbanes-Oxley contained several statements speaking to the purpose and requirements of the new securities statute.[153] The report stated

> [a]lthough we believe that existing criminal statutes are adequate to prosecute criminal acts involving securities fraud, we support the creation of a new securities fraud offense. In our view this provision will make it easier, in a limited class of cases, for prosecutors to prove securities fraud by eliminating, for example, the element that the mails or wires were used to further the scheme to defraud.[154]

The report further asserted that "[t]he provision would supplement the patchwork of existing technical securities law violations with a more general and less technical provision, with elements and intent requirements comparable to current bank fraud and health care fraud statutes."[155] Section 1348 would not lower the standard of criminal intent needed to convict securities fraud offenders.[156] Consistent with existing bank, health care, and securities fraud statutes, prosecutors would need to prove that a "defendant knowingly engaged in a scheme or artifice to defraud, or knowingly made false statements or representations to obtain money in a securities transaction."[157]

The intent of Congress in enacting Section 1348 and the species of embezzlement discussed in *Carpenter* became significant factors to the court in *Blaszczak*.[158]

IV. INSTANT DECISION

In *United States v. Blaszczak*, the Second Circuit held that the personal benefit test from Rule 10b-5's tipping jurisprudence does not apply in cases in which a person is charged with securities fraud under Section 1348.[159] The Second Circuit began its analysis by comparing the wording of Section 10(b) and Rule 10b-5 to Section 1348 and the fraud

153. *Id.* at 2, 32–38.

154. *Id.* at 30.

155. *Id* at 14.

156. *Id.* at 30.

157. *Id.*

158. 18 U.S.C. § 1348; Carpenter v. United States, 484 U.S. 19, 26–28 (1987); United States v. Blaszczak, 947 F.3d 19, 32–36 (2d Cir. 2019).

159. 947 F.3d 19, 37 (2d Cir. 2019). The Dissent, which will not be discussed in this Note, argued that the charges against the defendants should not be affirmed because the information misappropriated by the defendants was not property for the purposes of the fraud statutes. *Id.* at 46 (Kearse, J., dissenting).

prohibited by each of them.[160] First, it noted that while none of the existing statutes mentioned a personal benefit test, the provisions shared "similar text" and prohibited certain schemes to defraud.[161] One such scheme is the misappropriation theory of fraud.[162]

Next, the Second Circuit discussed the origin of the personal benefit test and linked it specifically to Section 10(b).[163] It noted that Congress's intention in creating Section 10(b) was to protect the free flow of information in the securities markets while eliminating the use of insider information for personal advantage.[164] The court acknowledged that *Dirks* accomplished this by holding that an insider did not breach his fiduciary duty by tipping the information unless he received a personal benefit.[165] The Second Circuit cited two cases in addition to *Dirks*, holding that the personal benefit test derives from Rule 10b-5 and is consistent with the purposes of securities laws.[166]

The Second Circuit then discussed the embezzlement theory of fraud used in *Carpenter*.[167] The court stated that once the personal benefit test is "untethered" from the statutory context of Section 10(b), the test finds no support in the embezzlement theory of fraud advanced by *Carpenter*.[168] The court reasoned that, in embezzlement, there is no additional requirement that an insider breach a duty to the owner of the information because it is impossible to embezzle money without committing a fraud.[169] Thus, the court noted that, because a breach of duty is inherent in the embezzlement theory from *Carpenter*, there is no additional requirement that the government prove a breach, let alone prove that an insider tipped the information for a personal benefit.[170] Therefore, the court concluded that the personal benefit test is not grounded in the embezzlement theory of fraud and it depends entirely upon the intent of the Exchange Act.[171]

---

160. *Id.* at 35.

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.* (quoting Dirks v. S.E.C., 463 U.S. 646, 662 (1983)).

165. *Id.* (citing *Dirks*, 463 U.S. at 662–64).

166. *Id.* at 35–36 (citing *Dirks*, 463 U.S. at 662–64); United States v. Chestman, 947 F.2d 551, 581 (2d Cir. 1991); United States v. Pinto-Thomaz, 352 F. Supp. 3d 287, 298 (S.D.N.Y. 2018)).

167. *Blaszczak*, 947 F.3d at 36 (citing Carpenter v. United States, 484 U.S. 19, 26–28 (1987)).

168. *Id.* (citing *Carpenter*, 484 U.S. at 26–28).

169. *Id.*

170. *Id.*

171. *Id.*

Next, the Second Circuit concluded that the embezzlement theory advanced by *Carpenter* applied to securities fraud under Section 1348.[172] To assess congressional intent in creating Section 1348, the court examined the Senate Judiciary Report for Sarbanes-Oxley.[173] Quoting the report, the court noted that Congress passed Section 1348 to supplement the existing patchwork of securities law provisions with a less technical and a more general provision with elements – including intent requirements – similar to the existing bank and healthcare fraud statutes.[174] The court concluded that the purpose of Section 1348 was to provide prosecutors with a different and broader enforcement mechanism than Rule 10b-5 to address securities fraud.[175] As a result, the court declined to extend the personal benefit test to Section 1348 because it does not share the same statutory purpose as Section 10(b).[176]

Finally, the court rejected the defendants' policy arguments in favor of extending the personal benefit test to Section 1348.[177] The defendants argued that if the test was not extended to Section 1348, prosecutors would be able to prosecute insider trading with less difficulty by bypassing the personal benefit test altogether.[178] However, this argument failed to persuade the court, which reasoned that Congress possessed the power to create a broader securities fraud provision and that it was not the role of the courts to "check that decision on policy grounds."[179]

Ultimately, the court concluded that the personal benefit test should not be extended to Section 1348 because it does not find support in the embezzlement theory of fraud in *Carpenter* and because Section 1348 serves a different statutory purpose than Section 10(b).[180]

V. COMMENT

While the decision in *Blaszczak* streamlined insider trading prosecution by making it easier for the government to prove guilt, it simultaneously complicated the relevant law by upending decades of carefully crafted judicial precedent and sowing confusion among

172. *Id.*
173. *Id.* (quoting S. REP. NO. 107-146, at 6 (2002)).
174. *Id.* (quoting S. REP. NO. 107-146, at 6 (2002)).
175. *Id.* at 36–37.
176. *Id.*
177. *Id.* at 37.
178. *Id.*
179. *Id.*
180. *Id.*

securities professionals.[181] Additionally, the two arguments put forth by the Second Circuit to support its decision not to extend the personal benefit test to Section 1348 have weaknesses. Lastly, a policy argument can be made against the result in this case.

A. *The Second Circuit Streamlined Prosecution but Complicated Existing Law*

By refusing to extend the personal benefit test to Section 1348, the Second Circuit reduced the burden on the government of proving insider trading and simplified the process of prosecuting it.[182] Rather than using Rule 10b-5, prosecutors can use Section 1348 to bypass the personal benefit test altogether.[183] In future prosecutions, based upon the jury instructions in *Blaszczak*, the government would only need to prove that a defendant knowingly and willingly participated in a fraudulent scheme to embezzle or convert confidential information.[184] This change is further evidenced by the nearly ten-page difference in the length of the jury instructions used for Rule 10b-5 and Section 1348.[185] It is not a stretch to believe that a jury of persons with little to no experience in securities law will have an easier time understanding the much shorter instructions of Section 1348. In determining guilt under Section 1348, the jury will not have to enter the mind of the defendants to determine whether the tipper received a personal benefit by tipping the information or whether the tippee knew or should have known that the tipper breached his duty.[186] The *Dirks* Court itself acknowledged the difficulty of proving a personal benefit, observing that "[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts."[187]

Despite this simplification, the Second Circuit also complicated insider trading law. Because of the result in *Blaszczak*, there are now two

181. *See id.*

182. *See id.*

183. *Id.*

184. *Id.* at 29.

185. Apps & Goldstein, *supra* note 50, at 2.

186. *See id.* Whereas the United States Supreme Court in *Dirks* requires proof that the tippee know *or* should know that the tipper divulged confidential information for personal benefit, the Second Circuit requires proof that the tippee *must* know. *Compare* Dirks v. S.E.C., 463 U.S. 646, 660 (1983), *with* United States v. Newman, 773 F.3d 438, 450 (2d Cir. 2014), *abrogated by* Salman v. United States, 137 S. Ct. 420 (2016).

187. *Dirks*, 463 U.S. at 664.

ways in which a person could be liable for insider trading.[188] The first method is via the traditional route using Rule 10b-5 by either a civil proceeding brought by the SEC or a criminal proceeding brought by the DOJ.[189] The second method allows the DOJ to bring criminal charges under Section 1348.[190] Though both methods attempt to accomplish the same goal of combatting insider trading, each achieves it in different way, which results in differing outcomes.[191] This is exemplified in *Blaszczak* by the opposing rulings on the Rule 10b-5 and Section 1348 charges.[192]

The investor community has expressed similar concerns over this decision.[193] The Alternative Investment Management Association,[194] in support of a rehearing en banc by the Second Circuit, argued that the ruling in *Blaszczak* creates "uncertainty and overdeterrence by removing a longstanding and well-known limitation" in the personal benefit test.[195] Although the Association agreed with the Second Circuit that the text of Section 1348 is materially identical to the text of Section 10(b) and Rule 10b-5, the Association argued that determining the source of information in connection with making trades can be difficult to ascertain in a practical sense.[196] It posited that the lack of clarity stemming from upending decades of precedent can create significant compliance costs, lead to inefficiency in market trading, and deter the use of lawfully obtained information.[197] This argument is similar to the sentiment of the *Dirks*

188. *Blaszczak*, 947 F.3d at 37.

189. Brett Atanasio, Mark Cahn, Elizabeth Mitchell, Theresa Titolo & Wilmer Hale, *Insider Trading Law Alert: The Second Circuit Clears the Path for Insider Trading Convictions Absent a Dirks Personal Benefit*, JD SUPRA (Jan. 8, 2020), https://www.jdsupra.com/legalnews/insider-trading-law-alert-the-second-82209/ [https://perma.cc/E4YH-WCRZ].

190. *Id.*

191. *Id.*

192. *Blaszczak*, 947 F.3d at 36–37.

193. *See* Brief of Amicus Curiae the Alternative Investment Management Association, Ltd. in Support of Rehearing En Banc at 1, United States v. Blaszczak, 947 F.3d 19 (2d Cir. 2019) (No. 18-2811), 2020 WL 1040817, at *1.

194. "The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in hedge fund and private credit assets." *About AIMA*, AIMA, https://www.aima.org/about.html (last visited Nov. 5, 2020).

195. Brief of Amicus Curiae the Alternative Investment Management Association, Ltd. in Support of Rehearing En Banc at 6, *Blaszczak*, 947 F.3d 19 (2d Cir. 2019) (No. 18-2811), 2020 WL 1040817, at 6.

196. *Id.* at 5–6.

197. *Id.*

Court, which stated that "it is essential…to have a guiding principle for those whose daily activities must be limited and instructed by the SEC's inside-trading rules."[198]

Beyond simply complicating existing law, the decision of the *Blaszczak* court also defies sound public policy.[199] Having similarly-worded statutes that punish analogous conduct differently does not make sense and leads to confusion and a lack of understanding by the public of what is and is not a lawful use of information. After forty years of judicial precedent creating insider trading law, it may be time for Congress to step in and properly enact a statute dedicated specifically to insider trading. Forty years of judicial decisions should give Congress enough test cases to create a provision that clearly delineates what is unlawful and details the proper tests for determining liability.

B. The Second Circuit's Two Arguments Have Weaknesses

In concluding that the personal benefit test does not apply to Section 1348, the *Blaszczak* court relied primarily upon a single quote from the Senate Judiciary Report for Sarbanes-Oxley.[200] The quoted portion of the report stated that Section 1348 would "supplement the patchwork of existing technical securities law violations with a more general and less technical provision, with elements and intent requirements comparable to current bank fraud and health care fraud statutes."[201] The language of the quoted statement is ambiguous and narrow in scope. What Congress meant when it said that this provision would supplement existing securities laws is arguably unclear. As discussed above, the practical effect of Section 1348 is to provide a bypass around the personal benefit test.[202] It seems unlikely that Congress's idea of supplementing a law is to render a portion of the law unnecessary. The language is also narrow in its scope in that it only refers to Section 1348 having similar elements and intent requirements to bank and health care fraud statutes.[203] It does not make

198. Dirks v. S.E.C., 463 U.S. 646, 664 (1983).

199. *Blaszczak*, 947 F.3d at 36–37.

200. *Id.* at 36.

201. S. REP. NO. 107-146, at 14 (2002).

202. *Blaszczak*, 947 F.3d at 36–37.

203. *See* S. REP. NO. 107-146, at 30 (2002) ("Like the bank and health care fraud statutes on which this provision is modeled, prosecutors must prove that a defendant knowingly engaged in a scheme or artifice to defraud, or knowingly made false statements or representations to obtain money in a securities transaction.").

any reference to current judicial doctrines in the existing securities laws, and it does not affirmatively discard any of them.[204]

Furthermore, the quoted language becomes even less persuasive when viewed in the context of the rest of the report. The report stated that Congress believed that existing securities fraud statues were adequate. However, it supported the creation of Section 1348 to make it easier to prosecute securities fraud in a "limited class of cases."[205] It seems speculative that Congress's idea of a limited class of cases included essentially all cases of securities fraud, as there is nothing to prevent the DOJ from using Section 1348 in every insider trading case going forward. In fact, one example given by the report as a reason for Section 1348 was the elimination of the requirement that the government prove the defendant used the mail or wires to conduct the fraud.[206] This example shows that Congress may have intended a more targeted approach rather than a wholesale change in securities law.

While reasonable minds may disagree as to the meaning of the language of the Senate report, the circumstances under which Congress created Section 1348 also calls into question what the actual intent of Congress was. As previously mentioned, Congress created Section 1348 at "lightning speed", amongst a political firestorm, in an election year, with a falling stock market, and in response to the financial scandals of Enron and others.[207] Sarbanes-Oxley spanned 150 pages and created duplicative and inconsistent provisions scattered across three separate titles of federal law.[208] It is also important to note that the financial scandals prompting Sarbanes-Oxley involved primarily accounting fraud and not insider trading.[209] In its haste, it is a possible that Congress did

204. *See generally id.*

205. *Id.* at 30.

206. *Id.*

207. Perino, *supra* note 16, at 671–72.

208. *Id.*

209. Rosemary Carlson, *The Enron Scandal That Prompted the Sarbanes-Oxley Act*, BALANCE SMALL BUS. (Nov. 16, 2019), https://www.thebalancesmb.com/sarbanes-oxley-act-and-the-enron-scandal-393497 [https://perma.cc/D75Q-QTB4]. Enron inflated profits and hid losses through dubious accounting practices that included unrealized future gains in current income statements and transferred troubled assets into limited partnerships. Peter Bondarenko, *Enron Scandal*, BRITANNICA (Oct. 7, 2019), https://www.britannica.com/event/Enron-scandal. WorldCom exaggerated its profits by inflating its net income and cash flows by recording expenses as investments. Adam Hayes, *The Rise and Fall of WorldCom*, INVESTOPEDIA (May 5, 2020), https://www.investopedia.com/terms/w/worldcom.asp [https://perma.cc/JQ6K-PTT5]. Officers of Adelphia Communications used approximately $2.3 billion in company funds for personal use and lied to investors

not realize the ramifications of its actions. These circumstances call into doubt the notion that Congress appreciated the significance of Section 1348 or understood that it would upend decades of securities law jurisprudence.

The Second Circuit's second argument that the personal benefit test is not required in the embezzlement theory of fraud is questionable. The *Blaszczak* court reasoned that the embezzlement theory did not require proof of a personal benefit or proof of a breach of duty because embezzlement is always fraudulent.[210] However, as argued in an amicus brief for the defense by law professors specializing in securities law, the cases on which the *Blaszczak* court relied in its embezzlement reasoning, *Carpenter* and *O'Hagan*, involved situations where the defendant already had a fiduciary duty and breached that duty by using the information.[211] In *Carpenter*, an employee used an employer's confidential information.[212] In *O'Hagan*, an attorney used confidential information from a firm's client.[213] Neither case addressed a situation where the defendant did not already owe a duty to disclose, so there is little for the Second Circuit to base its argument on. At a minimum, *O'Hagan* and *Carpenter* evidence that the United States Supreme Court implicitly, if not explicitly, requires a breach of a duty in the embezzlement theory.[214] In *Blaszczak*, because Blaszczak, Huber, and Olan owed no duty to CMS as outsiders, it seems that the personal benefit test would be necessary to determine whether a duty was inherited from Worrall, as an employee at CMS.[215] The Court's silence in *Carpenter* and *O'Hagan* cannot be definitive proof of the *Blaszczak* court's argument.[216]

---

about the company's financial condition. Barry Meier, *Corporate Conduct: The Overview; 2 Guilty in Fraud at a Cable Giant*, N.Y. TIMES (July 9, 2004), https://www.nytimes.com/2004/07/09/business/corporate-conduct-the-overview-2-guilty-in-fraud-at-a-cable-giant.html [https://perma.cc/7J6Q-NSPR].

210. United States v. Blaszczak, 947 F.3d 19, 36 (2d Cir. 2019).

211. Brief of Amici Curiae Law Professors in Support of Defendant-Appellants' Petition for Rehearing and for Rehearing En Banc at 9–10, *Blaszczak*, 947 F.3d 19 (2d Cir. 2019); *see* United States v. O'Hagan, 521 U.S. 642, 647 (1997); Carpenter v. United States, 484 U.S. 19, 27 (1987).

212. *Carpenter*, 484 U.S. at 23–24.

213. *O'Hagan*, 521 U.S. at 647–48.

214. Brief of Amici Curiae Law Professors in Support of Defendant-Appellants' Petition for Rehearing and for Rehearing En Banc at 9–10, *Blaszczak*, 947 F.3d 19 (2d Cir. 2019).

215. *Blaszczak*, 947 F.3d at 26–28.

216. *O'Hagan*, 521 U.S. 642 (1997); *Carpenter*, 484 U.S. 19 (1987); *Blaszczak*, 947 F.3d at 30–45.

VI. CONCLUSION

In *Blaszczak*, the Second Circuit upended decades of jurisprudence surrounding Rule 10b-5 and insider trading when it held that the personal benefit test does not apply to situations where a defendant is charged with securities fraud under Section 1348.[217] The court's decision complicates existing insider trading law by punishing similar conduct differently under either Rule 10b-5 or Section 1348, even while providing an easier path for prosecutors by allowing them to bypass the personal benefit test altogether.

217. *Blaszczak*, 947 F.3d at 37.