

Political intelligence and government contracting: Impact of *Blaszczak* opinion on insider trading prosecutions

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After the 2012 passage of the Stop Trading on Congressional Knowledge, or STOCK, Act, which, among other things, codified that members of Congress both owe a duty arising from a relationship of trust and confidence to Congress and are subject to the existing insider trading prohibitions, many envisioned an uptick in insider trading prosecutions related to political intelligence activity.

While the Department of Justice and the Securities and Exchange Commission have stepped up enforcement of insider trading involving material nonpublic governmental information, or governmental MNPI, a recent 2nd U.S. Circuit Court of Appeals decision unrelated to congressional trading may trigger increased political intelligence prosecutions.

In *United States v. Blaszczak*, 947 F.3d 19 (2d Cir. 2019),¹ the 2nd Circuit affirmed the ability of prosecutors to secure insider trading convictions even where they cannot prove that the tipper received a “personal benefit” in exchange for disclosing MNPI.

The appellate court held that the “personal benefit test” from *Dirks v. Securities and Exchange Commission*, 463 U.S. 646 (1983), need not be met when the government criminally charges insider trading behavior utilizing Title 18 securities fraud and wire fraud statutes, as opposed to the traditional methodology under the Securities Exchange Act utilizing Section 10b and Rule 10b-5.

The “personal benefit test” from *Dirks* need not be met when the government criminally charges insider trading behavior utilizing Title 18 securities fraud and wire fraud statutes.

The 2nd Circuit further held that confidential government information might constitute “property” for purposes of the Title 18 fraud and conversion statutes.

Taken together, these rulings make it easier for prosecutors to bring insider trading-related charges against current and former government insiders and the individuals who trade on governmental MNPI.

Whether that results in a significant increase in political intelligence enforcement actions remains to be seen, but *Blaszczak* may lead to increased insider trading enforcement in the area of government procurement.

RECENT INSIDER TRADING ACTIONS INVOLVING GOVERNMENTAL MNPI

To date, most civil and criminal insider trading enforcement activity involving the use of governmental MNPI has targeted the health care and pharmaceutical industries.

For example, in 2011 both the DOJ and the SEC charged a Food and Drug Administration chemist, Cheng-Yi Liang, who made use of his access to confidential pre-decisional information about drug approvals to trade for himself in advance of the public announcement of 28 separate FDA decisions, netting \$3.7 million.²

In 2015 political intelligence firm The Marwood Group settled civilly with the SEC after an investigation into its alleged use of nonpublic information obtained from both the Centers for Medicare and Medicaid Services and the FDA.³

The SEC and Marwood settled not on the basis that Marwood had engaged in any insider trading scheme, but instead that as a registered broker-dealer, Marwood “failed to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information.”

The SEC order explained that Marwood’s “principal means of communicating with clients was through research notes which often included previews of anticipated legislative or regulatory developments.

“Preview notes often included a predictive opinion of the likely outcome of government activity. ... To enhance Marwood’s ability to write research opining on future government regulatory events, Marwood encouraged its analysts to maintain contacts and seek information from personnel within the federal government.”

The order also stated that “Marwood’s research notes often opined on the future actions of government agencies, including the anticipated timing and content of agency rules and decisions.”

It went on to explain, “In making hiring decisions, Marwood also considered, in part, a prospective employee’s professional experience at a particular agency as well as contacts within the government.”

THE BLASZCZAK DECISION

The allegations in *Blaszczak* also implicate political intelligence and governmental MNPI allegedly obtained from the Centers for Medicare and Medicaid Services.

As set forth in the March 2018 superseding indictment filed against David Blaszczak, a former CMS employee turned political intelligence consultant, Blaszczak obtained confidential pre-decisional information about forthcoming agency rules and regulations from a former colleague at CMS. This information was typically related to how much CMS would pay for certain treatments or when the agency would publicize particular rules.

Blaszczak passed that information on to analysts at an investment advisor for several hedge funds. The hedge funds in turn used the information to take short positions in health care companies that would suffer financially from the impending regulations.

The superseding indictment brought two sets of insider trading charges against Blaszczak and his co-defendants. One set charged securities fraud, in violation of the Exchange Act and Title 18, 15 U.S.C.A. §§ 78j(b) and 78ff, and 18 U.S.C.A. § 1348. The other set charged wire fraud and conversion, in violation of 18 U.S.C.A. §§ 641 and 1343.

Adhering to the long-standing Supreme Court guidance from *Dirks*, the trial court in *Blaszczak* instructed the jury that it needed to find that the tipper provided inside information in exchange for a “personal benefit” in order to convict under Title 15 and Rule 10b-5. However, it refused to issue that instruction with respect to the Title 18 securities fraud and wire fraud charges.

On appeal, the defendants challenged the trial court’s instructions, arguing that the personal-benefit test applies equally to all prosecutions for insider trading behavior, regardless of which statute is utilized.

The 2nd Circuit disagreed, explaining that the personal-benefit test established in *Dirks* applies only to insider trading charges brought under Title 15.

First, because a breach of duty is inherent in the formulation of embezzlement, the government is not required to prove an additional breach in any specific manner, including though a personal benefit, the court said.

Second, the appellate court reasoned that “the personal-benefit test is a judge-made doctrine premised on the Exchange Act’s statutory purpose,” namely, to proscribe the use of inside information for personal gain.

Title 18’s securities fraud provision, 18 U.S.C.A. § 1348, which arose out of Sarbanes-Oxley, came later and was intended to broaden the government’s enforcement powers, according to the 2nd Circuit.

The circuit court summed up its reasoning by holding that “because the personal-benefit test is not grounded in the embezzlement theory of fraud, but rather depends entirely on the purpose of the Exchange Act, we decline to extend *Dirks* beyond the context of that statute.”

Blaszczak obtained confidential pre-decisional information about forthcoming Medicare and Medicaid rules and regulations from a former colleague, then passed that information to hedge fund analysts.

The *Blaszczak* defendants also challenged the trial court’s instruction that the jury could convict them of fraud under Title 18 if it found that the defendants embezzled confidential government information.

Both the wire fraud and securities fraud provisions of Title 18 prohibit the use of a scheme to obtain “property” through false or fraudulent pretenses. Under the defendants’ theory, a government agency’s confidential information is not “property” because the agency has only a regulatory interest in such information.

In affirming the trial court’s instructions, the 2nd Circuit explained that the government has a “right to exclude” and make “exclusive use” of its confidential pre-decisional information.

Keeping the information confidential protects the regulatory decision-making process and ensures fairness among stakeholders, according to the appellate court.

Finally, the agency in Blaszczak’s case had an economic interest in maintaining the confidentiality of its information in order to promote efficiency and prevent premature lobbying efforts, although the 2nd Circuit declined to hold that the government must have an economic interest in information for it to constitute property.

The circuit court also rejected the defendants’ argument that the government must suffer some monetary loss as a result of the fraud to have a property interest in its information.

Instead, the 2nd Circuit followed the Supreme Court’s precedent in *Carpenter v. United States*, 484 U.S. 19 (1987), which held that it is sufficient for the fraud victim to be “deprived of its right to exclusive use of the information.”

Given the government’s property interests, the 2nd Circuit concluded that, “in general, confidential government

information may constitute government ‘property’ for purposes of 18 U.S.C.A. §§ 1343 and 1348.”

Finally, on the conversion charge under 18 U.S.C.A. § 641, the 2nd Circuit rejected the defendants’ interpretation of what it means to “seriously interfere” with an agency’s use of its own confidential information.

The circuit court rejected the defendants’ argument that the government had to demonstrate that the disclosure of the information affected the rule the agency ultimately announced.

Instead, it ruled that “by definition,” the unauthorized disclosure of confidential, nonpublic governmental information “interferes with the agency’s right to exclude the public from accessing such information.”

Consequently, the necessary interference was complete upon the unauthorized disclosure. The jury was therefore free to determine, as it did, that the interference was “serious” and supported the conversion conviction.

NEW GOVERNMENT CONTRACTING RISKS AFTER *BLASZCZAK*

Government contractors and federal employees are already bound by strict rules related to procurement information, including, most notably, the Procurement Integrity Act. PIA prohibits the release of source selection and contractor bid or proposal information.

Until now, enforcement of PIA has primarily targeted use of such information in an anti-competitive manner. The *Blaszczak* opinion, however, could open a new enforcement front with respect to securities trading based on the release of nonpublic procurement information.

Public company government contractors are certainly susceptible to shifts in the price of their securities based on the award or non-award of particular government contracts.

Moreover, given the lucrative nature of political intelligence activity — both for the consultants obtaining the information and the traders utilizing it — those with nonpublic information related to potential government procurements can expect both current and former colleagues and industry contacts to reach out for “color” about potential contract awards.

As the *Blaszczak* court made clear, if that information is subsequently utilized to trade securities, the tipper and his downstream tippers may be criminally liable on a Title 18 insider trading theory, regardless of whether they sought or provided any benefit in exchange for the information.

An examination of the trial court’s jury instructions in the *Blaszczak* case highlights the particular risks for individuals in possession of governmental MNPI:

When instructing on the “scheme” element of Title 18 securities fraud, the trial court told the jury:

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.

The 2nd Circuit affirmed this instruction, as well as a set of instructions on fraud including:

Wire fraud “includes the act of embezzlement, which is a fraudulent appropriation to one’s own use of the money or property entrusted to somebody else.”

A Title 18 violation may result from disseminating non-public pre-decisional government information even if there is no personal benefit to the tipper.

The trial court further instructed the jury that to prove intent to defraud under Title 18 for both securities fraud and wire fraud:

The government must prove that the defendant acted with the intent to deprive CMS of something of value — for example, confidential, material, nonpublic information — by trading on the basis of that information or converting it to his own use by tipping it for use in trading.

Thus, a procurement officer who tips a third party, like a political intelligence contact, with nonpublic information about proposals, competitor bids or award decisions could be liable as a tipper, because pre-decisional procurement information may be “property” of the government, and “property” can be embezzled.

Assuming the requisite nexus to a securities transaction and intent elements are met, a Title 18 violation may result from disseminating this type of pre-decisional government information even if there is no personal benefit to the tipper.

The disclosure of nonpublic pre-decisional government information to a third party for trading purposes constitutes use of that information in a manner inconsistent with the tipper’s authorization to possess it, constituting embezzlement and exposing the tipper to Title 18 securities and wire fraud liability, as well as liability for criminal conversion.

In addition to government employees, government contractors and their employees are regularly exposed to pre-decisional governmental MNPI sourced from the government and often create it themselves — making them potentially the equivalent of the CMS insider in *Blaszczak*.

For example, systems engineering and technical assistance, or SETA, contractors are hired to assist the Defense Department’s components and acquisition programs.

SETA contractors often are privy to, if not the source of, pre-decisional MNPI regarding future Defense Department procurements, including what requirements a particular procurement may have and how those requirements might impact competition.

Because the government has a potential property interest in maintaining the secrecy of that information, it can be MNPI for securities fraud purposes.

If pre-decisional procurement information can be monetized by trading in the securities of an entity that might gain or lose a contract because of the SETA contractor's work, then the SETA contractor's employees become a potential source for pre-decisional governmental MNPI akin to the CMS rate information in *Blaszczak*.

A WAKE-UP CALL

Government contractors and their employees are well versed in the importance of maintaining the confidentiality of governmental information to protect from foreign threats as well as allegations of anti-competitive activity.

The *Blaszczak* decision, however, highlights a new risk wake-up call of which all in the procurement space should be aware.

Because the government can assert it has a property interest in maintaining the confidentiality of pre-decisional governmental MNPI, those who create it or have access to it are also at risk for criminal liability if they inappropriately share that information.

Whether further appellate review addresses the "personal benefit" aspect of the *Blaszczak* case remains to be seen, but the importance of maintaining government confidences has certainly been reaffirmed by the 2nd Circuit.

Notes

¹ The defendants filed a petition for en banc hearing.

² *Sec. & Exch. Comm'n v. Cheng*, No. 11-cv-00819 (D. Md. Nov. 29, 2011) (SEC judgment); *United States v. Cheng*, No. 11-cr-530, 2012 WL 710753 (D. Md. Mar. 5, 2012) (criminal judgment).

³ See *In the Matter of Marwood Grp. Research LLC, Respondent*, Release No. 4279 (Nov. 24, 2015).

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