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Political Intelligence

Looking Beyond *Blaszczak*: Lessons for Hedge Fund Managers

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Although the U.S. Court of Appeals for the Second Circuit's most recent decision in *U.S. v. Blaszczak* (*Blaszczak* 2) generated significant attention for its holding that a government agency's confidential information is not necessarily government "property" for purposes of criminal liability for Title 18 securities fraud, the more important lessons for hedge funds that engage political intelligence or any expert insights to inform their trading come from the earliest days of the case and the questions the Second Circuit left open. Firms that strengthened their compliance policies and procedures for conducting research on government actions when the Blaszczak investigation and eventual civil and criminal charges were announced should continue to stay the course, as *Blaszczak* 2 does not negate insider trading risk under Title 15 of the United States Code. Firms that did not, however, should take this opportunity to do so, as the concurring and dissenting opinions in *Blaszczak* 2 reveal unresolved tensions among the judiciary regarding the propriety and value of political intelligence firms for the financial markets.

This article summarizes the history of the Blaszczak cases, identifies lessons from the litigation for hedge fund managers and posits several unanswered questions left in the wake of the latest decision.

For more on *Blaszczak* 2, see "Second Circuit Holds That Certain Political Intelligence Is Not 'Property' Under Title 18" (Feb. 16, 2023).

Blaszczak 2 Recap

The prosecution in *Blaszczak* stemmed from the passing of nonpublic information by a federal employee at the Centers for Medicare & Medicaid Services (CMS) to David B. Blaszczak, a former CMS colleague who now worked as a political intelligence consultant to hedge funds. The information concerned forthcoming changes to certain CMS reimbursement rates. Blaszczak passed the information on to his hedge fund clients, including partners at Deerfield Management Company, L.P., who engaged in profitable short sales in companies that would be negatively affected by the reimbursement rate changes.

The DOJ charged Blaszczak, the CMS employee and the Deerfield partners with securities fraud under Title 15, as well as various counts of theft of government property, wire fraud, securities fraud and related conspiracy charges under Title 18. After trial in 2018, the jury acquitted the defendants on all of the traditional "insider trading" charges under Title 15. The defendants were largely convicted on the Title 18 charges, however, leading to two hotly contested questions of law for the Second Circuit:

1. Does CMS and other agencies' nonpublic information constitute a "thing of value" to the government under the theft of government property statute or "property" under the wire and security fraud statutes, under Title 18?
2. Should the courts apply the same "personal benefit" test to Title 18 insider trading charges as they do for Title 15 charges?

In December 2019, the Second Circuit decided both questions in the government's favor (*Blaszczak* 1) – the CMS confidential information was a "thing of value" and "property" of the government, and prosecutors did not have to prove the tipper received any personal benefit for passing the information (and that the tippees were aware of the tipper's personal benefit) to secure a conviction under Title 18.

The defendants petitioned for certiorari and, in 2020, got the benefit of the U.S. Supreme Court's decision in *Kelly v. U.S.*, which overturned New Jersey officials' convictions for wire fraud and fraud on a federally funded entity in the "Bridgegate" scandal on the ground that the officials' interference with toll plaza access lanes did not deprive the government of any "property" under those statutes. *Kelly* caused the DOJ to change its position on the first *Blaszczak* question – the government now supported the defendants' position that information about a forthcoming agency action was not a "thing of value" or "property" to the government for purposes of Title 18 liability.

See "Supreme Court Directs Second Circuit to Take a Fresh Look at Insider Trading Prosecution" (Feb. 25, 2021).

On remand, in *Blaszczak* 2, the Second Circuit noted the government's confession of error and conducted its own analysis to conclude that "while CMS seeks to maintain confidentiality as to its planned regulations – and the regulations can plainly have either a favorable or an adverse effect on certain business entities' fortunes – a planned CMS regulation, even if disclosed to outsiders prematurely, remains within the exclusive control of CMS" and "has no direct impact on the government's fisc." Thus, "merely obtaining advance information as to what the agency's preferred regulation would be, and when it would be announced, cannot properly be considered the agency's money or property or a thing of value that could be 'convert[ed],'" the Second Circuit found.

Lessons from *Blaszczak*'s History

The DOJ's change of position and the Second Circuit's application of *Kelly* in *Blaszczak* 2 are undoubtedly significant for individuals and entities facing charges or under investigation for alleged

dealing in or trading on misappropriated information. For hedge funds and other industry participants making day-to-day decisions about whether and how to seek out political intelligence or other expert insights, however, the critical enforcement actions took place years ago in 2017, when the DOJ brought Title 15 insider trading charges alongside the more aggressive Title 18 charges, and the SEC secured significant settlements from Deerfield and another fund that engaged Blaszczak.

Prosecutors Took Traditional Insider Trading Charges to Trial

The Second Circuit's decision to vacate the defendants' Title 18 convictions in *Blaszczak* 2 does not mean that using political intelligence in trading is now without risk. Hedge funds and their employees should not lose sight of the fact that prosecutors charged each of the defendants – the CMS employee alleged "tipper"; Blaszczak, the political intelligence consultant alleged "tippee"; and the hedge fund employee subsequent tippees – with traditional insider trading under Title 15. Yes, the jury acquitted them of those charges, but the allegations came after years of investigation and were deemed factually and legally sufficient to be presented to a jury.

As the Second Circuit reiterated in *Blaszczak* 2, for violations of the Title 15 securities laws, "the actual and intended victims of the alleged frauds would have been investors in the market for securities of the companies whose fortunes would be affected by the regulations promulgated by CMS," so there was no need to prove the government had been deprived of property. Although it is impossible to know for certain why the jury acquitted on the Title 15 insider trading charges while convicting on the Title 18 securities fraud charges based on the same conduct, a good guess is the application of the "personal benefit" test to Title 15 cases but not (at least then and for now) Title 18 cases.

But even if the jury found that the CMS employee did not receive a personal benefit when he shared the nonpublic information with Blaszczak, hedge fund managers cannot reasonably take comfort in the acquittal to guide their day-to-day actions. Rather, a robust compliance program will seek to minimize the risks that likely led to the charges in the first place, including restrictions on the manner and frequency of contacts with political intelligence consultants.

For example, instead of Deerfield employees only reaching out to Blaszczak with appropriate and well-formed questions, they took his calls on an ad hoc basis, likely creating the perception that he was passing on inside information as he was receiving it. In addition, the frequency of Deerfield employee contacts with Blaszczak were a sign of his information being unusually prescient and also fostered overfamiliarity, which led to unfortunate emails such as Deerfield employee Jordan Fogel's reaching out to Blaszczak in hopes of "'re-ignit[ing] the Blaszczak-Fogel money printing machine.'"

To avoid similar issues, hedge fund managers should consider:

- limiting how many times employees may speak with an expert on an annual or other periodic basis;
- requiring employees to speak with experts only on scheduled calls that are calendared on the firm's systems and visible to compliance personnel, *i.e.*, no ad hoc calls from the expert; and

- requiring employees to reiterate at the beginning of each call that they do not want to receive material nonpublic information (MNPI) or other confidential information and that the expert should not convey such information.

Fund Managers Censured and Penalized Significantly by the SEC

Beyond potential criminal exposure, the risk of SEC action should be more than enough to keep fund managers vigilant about not receiving MNPI, whether or not that information is considered government property. In addition to the DOJ's case, the SEC simultaneously filed a civil complaint against the same four criminal defendants and later announced that Deerfield would pay more than $4.6 million to "settle charges that it failed to establish, maintain, and enforce policies and procedures reasonably designed to prevent the misuse of inside information, including information about confidential government decisions."

The SEC's press release criticized Deerfield for:

- having policies and procedures that required "only an initial review of the research firms' own policies and procedures";
- putting "the burden on its own employees to police themselves by identifying issues and informing supervisors"; and
- ignoring red flags that Blaszczak might be conveying MNPI, including an email from Blaszczak that said he had "heard from a reliable [CMS] source" that CMS was about to issue a regulation and an internal Deerfield email noting that Blaszczak "ha[d] a guy" at a "closed-door" government meeting.

See "Hedge Fund Manager Deerfield Fined $4.7 Million for Failing to Adopt Insider Trading Compliance Policies Tailored to the Firm's Specific Risks" (Sep. 21, 2017).

The following year, the SEC also settled charges against a second hedge fund manager, Visium Asset Management, LP, for various violations, including trading based on confidential information received from Blaszczak. The SEC's order noted that Visium had robust-looking written policies and procedures concerning prevention of the misuse of MNPI, including a "Checklist [for] Resolving Issues Concerning Insider Trading" that recommended, among other things, that employees should:

- ensure all agreements with third-party research consultants contain an insider trading prohibition disclosure; and
- remind consultants that the firm should not be a recipient of actual or potential MNPI.

The SEC nonetheless alleged that Visium had "inadequate measures in place to enforce its policies and to ensure the Checklist was followed, and took inadequate steps to monitor employees' communications with consultants." Visium ultimately agreed to pay more than $10 million in disgorgement, interest and penalties.

See "Charges of Fraudulent Valuation, Insider Trading and Failure to Supervise Employees Cost Manager and CFO More Than $10 Million in SEC Settlement" (Jun. 14, 2018).

The SEC's Blaszczak-related enforcement actions should have been a wake-up call to hedge fund managers and others in the investment industry that having written policies and training materials, and conducting initial diligence on alternative data sources, although necessary, are not sufficient in themselves. For example:

- Written policies and procedures must actually be carried out and documented. Failure to enforce the firm's own stated policies may be just as detrimental as not having policies at all.
- Internal training and external diligence cannot be one-shot exercises. In addition to periodic updates, managers should conduct spot checks – particularly if an employee's or consultant's record or frequency of contact appears outside the norm.

Blaszczak 2's Unanswered Questions for Hedge Funds

Blaszczak 2 leaves a number of unanswered questions. Foremost among them is the second question thought to be decided by *Blaszczak* 1: whether the courts should apply the same "personal benefit" test to Title 18 insider trading charges as they do for Title 15 charges. In writing for the majority in *Blaszczak* 1, Judge Sullivan held that the personal benefit test should not apply to Title 18 charges. The Supreme Court vacated *Blaszczak* 1 for reconsideration in light of *Kelly*. But because the Second Circuit, now with Judge Kearse writing for the majority, held that the CMS information was not government property, the panel did not need to rule on the personal benefit question again.

Blaszczak 2 also leaves unanswered whether its analysis of what constitutes "property" applies with equal force to private entities. The majority contrasted the information about the expected timing and direction of CMS's pending decision about reimbursement rates with the type of confidential information that was a commercial entity's "stock in trade, to be gathered at the cost of enterprise, organization, skill, labor, and money, and to be distributed and sold to those who [would] pay money for it," in *Carpenter v. U.S.*, which involved information about *The Wall Street Journal*'s publication schedule and forthcoming columns. Under that analysis:

- Does a company have a property interest in information about when it plans to launch a new product or the direction of its earnings, topics generally thought to be core MNPI?
- Does a company have a property interest in information that can be data mined from its website if the information is incidental to its main line of commerce?
- What if the company gathers some of that information itself to sell to those who would pay money for it?

See "Risk Alert Cites Compliance Issues Regarding Advisers' Handling of MNPI" (May 19, 2022).

More broadly, the concurring and dissenting opinions in *Blaszczak* 2 reveal unresolved tensions among the judiciary regarding the propriety and value of political intelligence and other expert insight firms. Judge Walker – writing to encourage his colleagues, the Supreme Court and Congress to address the anomaly of requiring a personal benefit test for civil and criminal insider trading liability under Title 15 but not securities and wire fraud based on insider trading under Title 18 – saw the "ferret[ing] out" of information from corporate insiders as a positive:

> The government has expressly acknowledged that securities analysts, who routinely "ferret out and analyze information" from corporate insiders to price accurately a security, are critical to a functioning market. But when the bounds of permissible conduct are not clearly delineated, parties are prevented "from ordering their actions in accord with legal requirements."... [T]he personal benefit...element provides corporate insiders and analysts (and their attorneys) with notice of "when the line is crossed." Without it, corporate insiders may be more reticent to share information with analysts in the ordinary course of business and analysts who do receive company information may be less likely to act on it for fear of running afoul of §1348.

In contrast, Judge Sullivan, now in the minority, had a more skeptical view of this activity, writing, "The majority opinion effectively permits sophisticated insiders to leverage their access to confidential government information and sell it to the highest bidders – in this case, hedge funds that used the confidential information to make millions shorting the stocks of public companies affected by CMS's regulations."

Judge Sullivan continued:

> I fear that the only winners in this appeal will be the defendants – sophisticated insiders who misappropriated confidential government information to enrich themselves and their associated hedge funds – and those like them who will be emboldened by today's decision to believe that the broad proscriptions of the federal fraud statutes do not in fact mean what they say. It is clear, to me at least, that the defendants are not the victims of prosecutorial overreach or vague statutes; they are instead the beneficiaries of a windfall generated by a flawed legal analysis.

In the face of these unresolved questions and tensions, hedge fund managers would do well to take steps to ensure that they have, and follow, procedures for interacting with political intelligence and other expert consultants that mitigate the risk of receiving MNPI regardless of whether the information is considered government property, including:

- limiting the manner and frequency of interactions;
- conducting spot checks; and
- undertaking additional diligence if information ever seems "too good."

For more on political intelligence, see "Mitigating Insider Trading Risks: Expert Networks, Political Intelligence, Meetings With Management, Data Rooms, Information Barriers and Office Sharing

(Part Two of Two)" (Oct. 11, 2018); "Self-Evaluation Policies Are Insufficient for Political Intelligence Firms to Avoid MNPI Violations" (Dec. 17, 2015); and "How Can Hedge Fund Managers Identify and Mitigate Insider Trading Risks Associated with Gathering and Using Political Intelligence?" (Jul. 11, 2013).

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